HELSINGIN YLIOPISTO
HELSINGFORS UNIVERSITET
UNIVERSITY OF HELSINKI

Master's Programme in International Business Law

"Fear of Delaware effect after Inspire Art; rhetoric or reality? Is harmonisation a solution?"

Sheikh Monayem Hossain

Student number: 014732814

Supervisor: Professor Ville Pönkä

Spring 2020

Abstract

Freedom of establishment granted to nationals of Member States which is enshrined in the Article 49 of the Treaty on the Functioning of the European Union (TFEU) is one of the fundamental freedoms granted by the Treaty that extends to companies by virtue of Article 54 of TFEU. In the absence of company law harmonisation, the increased corporate mobility may lead to a competition between legal orders which in turn can produce laxer law in the Community and this fear is known as fear of Delaware effect in the European Union. Since company law is not harmonised in the EU, there are differences among national conflicts of laws rules of the Member States and many Member States felt justified to use the real seat doctrine as a defensive mechanism for negating the European Delaware. However, the judgment in *Centros*[1] changed this situation and established legal forum shopping as a good practice. Subsequently the judgment in *Überseering*[2] reaffirmed the principle of mutual recognition in the EU. Therefore these two judgments established the market for company incorporations and as a result it was feared that, a European Delaware is going to emerge. The purpose of this paper is to assess whether this fear is justifiable. For this purpose the traditional way of conducting legal research; looking for sources and by reading and evaluating them, using them with critical thinking and judgments, was used as a method in this paper. The paper found that, although after the judgments in *Centros, Überseering* and *Inspire Art*[3] it was feared that a European Delaware is going to emerge; this fear was unreasonable. It is particularly because the regulatory competition not only needs the establishment of a market for company incorporations but also needs the willingness of the Member States and the companies to compete. The judgments in *Centros* and *Überseering* only established a partial market for company incorporation because a market for company incorporation needs both the ability to forum shop and the ability to reincorporate a company in another Member State. This paper also looked into the incentives for competition from the Member State's and company's perspective. Eventually, market for company incorporations was established after the judgment in *Polbud* which allowed cross-border conversion of companies; making regulatory competition possible in the EU. As a result, this paper proposed company law harmonisation as possible solution to the problem. It is high time the Commission took the initiative to make Community company law uniform so that a European Delaware does not emerge.

[1] ECJ Case C-212/97 of 9 March 1999, ECR 1999, 1-1459, Centros
[2] ECJ Case C-208/00 of 5 November 2002, ECR 2000, 1-9919, Überseering,
[3] ECJ Case C-167/01 of 30 September 2003, in: DB 2003, 2219, Inspire Art,

Contents

Abbreviations

ACC = Amsterdam Chamber of Commerce

ATAD = Anti-Tax Avoidance Directive (ATAD Directive

Art.= Article

CJEU = Court of Justice of the European Union

CCCTB = Common Consolidated Corporate Tax Base

EC= European Communities

ECJ = European Court of Justice

EEC= European Economic Community

EU = European Union

SE = Societas Europaea

TEC = Treaty establishing the European Community

TFEU = Treaty on the Functioning of the European Union

US= United States

USA= United States of America

WFBV= Wet op de Formeel Buitenlandse Vennootschappen

Introduction:

Freedom of establishment enshrined in Article 49 of the Treaty on the Functioning of the European Union (TFEU)[4] (ex Article 43 TEC) prohibits restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State. Companies formed under the law of a Member State also benefits from the freedom of establishment as legal person by virtue of Article 54 TFEU (Ex Art. 48 TEC). As the company law is not completely harmonised in the European Union; the conflict of law rules become problematic for the companies that want to emigrate from one Member State to another Member State depending on which theory the Member State where the company has its registered office is subscribed to. This may seriously impede freedom of establishment provided by Treaty. Few years ago the ECJ (European Court of Justice) has dealt with a number of cases involved this kind of situation and *Centros*[5], *Überseering*[6] and *Inspire Art*[7] are notable among them. After *Centros*, legal forum shopping became a good practice in the EU and after *Überseering*, which reaffirmed the principle of recognition in the Community; these two judgments established a market for company incorporations in the EU. However, it is feared that this might give rise to a Delaware style competition between legal orders leading to the production of laxer laws in the Community and even establish a European Delaware. The purpose of this paper is access whether this fear is legitimate or not and for doing so, Chapter 1 of this paper went on to access the effects of real seat doctrine on freedom of establishment. After that it discussed the historical background of this fear, corporate conflicts of laws rules in the EU and its effect on corporate mobility; and early attempts of harmonisation in the Community respectively. Chapter 2 discussed the jurisprudence in this area decided by the ECJ and chapter 3 discussed their impact on the real seat theory as well as on the internal market. As regulatory competition not only needs the establishment of market for company incorporations but also needs the willingness of the Member States and companies to take part in that competition; the subsequent part of the paper went on to look for the state's financial incentives as well the company's incentive to take part in the competition. The paper then discussed about reincorporation in chapter 5 where it found that in the absence of company's ability to reincorporate, the fear of Delaware

[4] TFEU; Article 49 << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12012E049>>
[5] ECJ Case C-212/97 of 9 March 1999, ECR 1999, 1-1459. (Centros)
[6] ECJ Case C-208/00 of 5 November 2002, ECR 2000, 1-9919. (Überseering)
[7] ECJ Case C-167/01 of 30 September 2003, in: DB 2003, 2219. (Inspire Art)

effect is rather rhetoric than reality because market for company incorporations is not complete if the company does not enjoy the right to reincorporate the company in another Member State. This section also discussed the present state of the community law and found that law regarding reincorporations is gradually changing especially after the recent judgement in *Polbud*[8]. And finally, chapter 6 of this paper discussed the possibility of a race to the bottom in the EU after *Polbud;* since *Centros* coupled with *Polbud* established a market for company incorporations. That section also sheds some light on whether harmonisation could be a possible solution to the problem regarding Delaware effect in the EU.

Chapter 1

1.1 Freedom of Establishment:

Freedom of establishment is one of the fundamental rights granted by the Treaty on the Functioning of the European Union (TFEU) and Article 49 of the Treaty (Ex Article 43 TEC) provides:

"… restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 54, under the conditions laid down for its own nationals by the law of the country where such establishment is effected".[9]

The freedom of establishment not only protects individuals of Member State but also companies formed under the law of another Member State and for this purpose, Article 54 TFEU (Ex Article 48 TEC) provides:

"Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community

[8] Case C-106/16, Polbud
[9] Treaty of the Functioning of the European Union (TFEU); available << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12012E049>>, art 49

shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

"Companies or firms" means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making".[10]

Although Article 54 (TFEU) extends the freedom of establishment to corporations, they (companies) do not fully benefit from this because of the effects of the real seat doctrine for corporate mobility. Even though the real seat doctrine has been used as a defensive mechanism against the possibility of Delaware effects in the past, there has been extensive discussion about whether the doctrine is in line with the freedom of establishment enshrined in the Treaty Article 49 and 54 (TFEU) especially after the decision in *Centros*[11] which ignited the debate on its compliance with Article 54 of the Treaty and this case will be discussed in the later part of this paper.[12]

Establishment of a single market with no barriers was the main goal of European Union since the beginning and therefore Article 49 and 54 TFEU (ex Article 43 and 48 TEC) provide nationals as well as companies with the freedom of establishment. Like the nationals of the Member States the companies enjoy the freedom of establishment through the means of primary and secondary establishment where primary establishment means that an existing company enjoys the right to transfer all or the main part of its business activities to another Member State, or it may start up new business activities in another Member State by taking part in the incorporation of the company in that State.[13] On the other hand, secondary establishment is the situation when an existing company established in one Member State sets up of an agency, a branch, or a subsidiary in another Member State without moving its home office.[14] However, to what extent an existing corporation enjoy the right of primary establishment under the TFEU is not immediately clear. Again, the grant of the right of primary establishment by the TFEU is of great importance for the establishment of a market for company incorporations in the European Union and a landmark case with regard to the

[10] TFEU, art. 54.
[11] ECJ Case C-212/97, (Centros)
[12] Catherine Hoist, *European Company Law after Centros: Is the EU on the Road to Delaware*, 8 Colum. J. Eur. L. 323 (2002), P19
[13] Ulvi ALTINIŞIK, *Free Movement of Companies within the EU*, Ankara Bar Review 2012/ 1
[14] Paul Craig & Grianne De Borca, EC LAW: TEXTS, CASES & MATERIALS 733, 755-56 (1998); Catherine Barnard, The Substantive Law of the EU: The Four Freedoms, (Oxford:OUP second Edition 2007), 331.

transfer of primary establishment of a company from one Member State to another is Daily Mail which will be discussed in later part of this paper.

1.2 Historical background of the fear of Delaware effect in EU

The main reason why European legal scholars draw analogy between the company law regulations from the United States with the European Union is that they seem to have a lot in common.[15] For example; corporations are regulated at the state level in the United States and as a result the corporate laws between different states differ. Similarly, in the European Union; Member States (in the absence of harmonisation) are vested with the power to regulate companies.[16] Again, the sates in America follow the internal affair doctrine which means companies are governed by the law of the state where it is incorporated regardless of any economic activity or location of the central administration.[17] The European counterparts of the internal affair doctrine is known as the "incorporation state" doctrine which is used by many Member States; whereas the other doctrine that dominates this part of the world is the real seat doctrine which raised the concern among the scholars whether it is compatible with the freedom of establishment of the TFEU or not. Its non-compatibility would mean that the doctrine of incorporation state would prevail in the European Union.[18]

Though, the American and European company law regulations are similar in some ways, they are not devoid of any differences. For example, in the United States majority of the scholars believe that corporate law should primarily regulate the relationship between the shareholders and the directors. The American corporate law mainly focuses on the interest of the shareholders; the interests of the other stakeholders are not dealt with in the corporate laws but addressed in the other area of law. On the other hand, in Europe especially in the continental Europe, stakeholder primacy model is dominant and majority of the scholars in this region are in the opinion that company law should regulate more than just the relationship between the directors and the shareholders; it should also deal with the interests

[15] Hanne Sondergaard Birkmose, *A Market for Company Incorporations in the European Union - Is Uberseering the Beginning of the End*, 13 Tul. J. Int'l & Comp. L. 55 (2005)
[16] Birkmose, *A Market for Company Incorporations in the European Union* (n 15)
[17] Birkmose, *A Market for Company Incorporations in the European Union* (n 15)
[18] Birkmose, *A Market for Company Incorporations in the European Union* (n 15)

of the other stakeholders like creditors and employees. Consequently, this stakeholder primacy model is also reflected in different EU legislations.[19]

Current theories regarding jurisdictional competition is broadly divided into two spectrum; the first being that "Delaware's quest for revenue has led it to enact laws favourable to management at the expense of shareholders"[20] (which is backed by Professors William Cary, Donald Schwartz, and Melvin Eisenberg who follow the tradition of Adolph Berle and Gardiner Means.[21] The other theory is the corporate federalist theory where the market-oriented legal scholars such as Ralph Winter, Judge Frank Easterbrook, Professor Daniel Fischel, Roberta Romano and others believe that Delaware "has achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders' welfare."[22]

The existence of the modern 'race to the bottom' theory of corporate law can be traced back to Professor William Cary's seminal work; "Federalism and Corporate Law: Reflections upon Delaware".[23] Throughout the twentieth century the individual states in the USA has progressively deregulated their company laws in order to attract company incorporations which has arguably led to a 'race to the bottom'. Since the State of Delaware managed to attract the vast majority of company incorporation, it is considered to be the winner of this competition[24] and thus this phenomena is also known as the 'Delaware effect'. Consequently, this term has been extensively used in various occasion in Europe to refer to an undesirable situation. However, the dominance of Delaware corporate law among the large public corporation in the United States which arguably led to a liberalization of corporate law was known in Europe in the 1960s even before the publication of Professor William Cary's work and it is evident in some of the scholars' writing; for example, in 1973 Clive Schmitthoff stated that, "First, unless the national company laws in the Community are identical in all

---

[19] Birkmose, *A Market for Company Incorporations in the European Union (*n 15)

[20] Jonathan R. Macey; Geoffrey P. Miller, Toward an Interest-GroupTheory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987)

[21] A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[22] Fischel, The "Race to the Bottom" Revisited:Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. REV. 913, 919-20 (1982);

[23] Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 666 (1974). It is derived from the famous dissenting opinion of Justice Brandeis in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933), describing competition among states for corporate chartering revenues as a race "not of diligence but of laxity."

[24] More than 50 % of the companies listed on the New York Stock Exchange are incorporated in Delaware, 60 % of the companies that make up the Fortune 500. See Mark J. Loewenstein, 'Delaware as Demon: Twenty-five Years After Professor Cary's Polemic' 71 University of Colorado Law Review 1 (2000). See further <<http://www.state.de.us/corp/default.shtml>>

essential aspects, a movement of companies to the state with the laxest company law will take place in the Community. If it may be said without giving offence to our friends in the U.S.A., the Community cannot tolerate the establishment of a Delaware in its territory."[25]

Since the inception of the European Union the spectre of corporate law arbitrage haunted the community and during the negotiation of the EEC Treaty many delegates of different counties especially from France were concerned that the Netherlands might become the Delaware of Europe because of its corporate laws' permissive nature. Three cases from the Court of Justice of the European Union (CJEU) in the late nineties and early two-thousands: *Centros* (1999)[26], *Überseering* (2002)[27], and *Inspire Art* (2003)[28] reignited the concern; where the Court applied freedom of establishment to corporations and paved the way for market for company incorporation in the EU. These judgements resulted in a situation which was sought to be avoided for many decades because of its potential to undermine national corporate law.[29] As a defensive mechanism to battle the situation, the traditional conflicts of law rules (real seat theory) and some other protectionist tools were used throughout the EU to stop pseudo foreign corporations at the border. Though, in the early years of the EEC it was expected that company law would be harmonized to a certain degree so that free movement of corporations would create a problem; the harmonization programme in the Community stalled and thus, the "Member States felt justified in maintaining protectionist measures impeding free choice of corporate law".[30]

1.3 Corporate conflict of laws rules in the European Union:

In the European Union two different conflict of laws rules are applied and they are; real seat doctrine and incorporation state doctrine which is very similar to the internal affairs rule that is used by all the states across the United States. Inter-state company mobility as well as companies' ability to forum shop is greatly affected by the corporate conflicts of law rules. A

[25] Clive M. Schmitthoff, The Future of the European Company Law Scene, in THE HARMON1SATION OF EUROPEAN COMPANY LAW 3, 9 (Clive M. Schmitthoffed., 1973).
[26] Case C-212/97, Centros Ltd.
[27] Case C-208/00, Überseering BV
[28] Case C-167/01, 2003 E.C.R. I- 10155. Inspire Art Ltd.,
[29] Macey; Miller, Toward an Interest-GroupTheory of Delaware Corporate Law, (n 20)
[30] Martin Gelter, Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law (February 13, 2015), Available at SSRN: <<https://ssrn.com/abstract=2564765 or http://dx.doi.org/10.2139/ssrn.2564765>>

state doctrine along with the real seat doctrine in the EU will be presented in the following sections.[31]

1.3.1 The incorporation state doctrine:

According to the theory of Incorporation a company is governed by the law of the state where it was validly formed. This doctrine is related to the registration state doctrine. Only a minority of the Member States of the community stick to the doctrine of incorporation and the most notable countries are; the United Kingdom, Ireland, Denmark, Netherlands and Switzerland. Under this system, it is possible for a company to transfer its effective seat from one State to another without losing its legal personality and status as a company under the law of the State of incorporation but it's not possible to transfer its registered office to another State.[32]

The doctrine of incorporation is primarily known for its ease of determining the jurisdiction to which a company is subject to. The company's jurisdiction can be objectively established by the place where it is incorporated and does not need any factual evaluation of any business activities.[33] As it is possible for the company to transfer the central administration out of the state of incorporation without losing its legal identity because the connecting factor is whether the company had been formed in accordance with the legal requirements of the state of incorporation; this doctrine is not in conflict with the freedom of establishment in any way and rather it promotes the concept of single market as the company is free to choose the most favourable company law in the Community by locating its registered office in that state and also by being able to move throughout the community without having to comply with the company laws applicable to the host State. However, the situation where a most favourable company law regime is identified and the alleged abuse of the freedom of establishment by the companies by being incorporated in that particular state is not devoid of criticism. Additionally, it raise the question whether it is appropriate for a company to be able to be incorporated in a state where it has very limited economic activity or no economic activity at all; the only connection it has with that state is the registered office. Particularly, this could lead to the undesirable situation where companies can act opportunistically and incorporate

[31] Birkmose, A Market for Company Incorporations in the European Union (n 15)
[32] Anne Looijestijn-Clearie, Centros LTD - A Complete U-Turn in the Right of Establishment for Companies, 49 Int'l & Comp. L.Q. 621 (2000)
[33] Birkmose, A Market for Company Incorporations in the European Union (n 15)

the company in a doctrine of incorporation Member State so that it can circumvent the mandatory company law of the State where it has its primary economic activities. Therefore, the circumvention of law has been a major criticism of the theory of incorporation in the European debate. Furthermore, it might give rise of 'mailbox' companies in the Community leaving different stakeholders, for example; employees, creditors and investors of the company without adequate protection in the host Member State. Moreover, the legislators and scholars in the EU are concerned that it could lead to a situation where competition between Member States for incorporation might arise; which in turn can drive the Member States to produce laxer laws.[34]

1.3.2 The real seat doctrine:

The most popular conflict of laws rules which is used by majority of the members of the European Union especially the continental European Member States in the EU is the real seat (siège reel) doctrine, according to that a company must be incorporated in the state where its effective seat is; in other words in order to be recognised as a limited liability company it must be incorporated in the same state where it has its central administration (seat of management).[35] The doctrine uses the centre of administration (central office, siège réel) as an objective connecting factor where a conflict of company laws must be settled according to the law where the central administration is located. The meaning of the central administration is defined by the Courts as the place where "the internal management decisions are transformed into day to day activities" and it is not to be confused with the place where strategies are devised nor the seat provided by the charter.[36] The doctrine is protective by its nature which intends to protect the interests of the stakeholders associated with the company because when a company is incorporated in the state where its corporate centre of gravity is located, it would not be able to circumvent certain mandatory company law rules of the state where it has its main economic activities and thus the stakeholders would be better protected. On the other hand, the doctrine of incorporation has been criticised particularly because of its being prone to the circumvention of the mandatory company law of the country where the company has most of its economic activities which in turn might lead to a competition

[34] Birkmose, *A Market for Company Incorporations in the European Union* (n 15), 13-14
[35] Birkmose, *A Market for Company Incorporations in the European Union* (n 15), 6.
[36] Wulf-Henning Roth, *From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law,* 52 Int'l & Comp. L.Q. 177 (2003), 5-6

between legal orders. “The right to set up a company in the state that offers the most favourable legal regime and the right to reincorporate an existing company are both preconditions for regulatory competition”.[37] As competition between legal orders is related to freedom of establishment and corporate mobility, which is mentioned in the earlier part of this work; harmonisation of community company law was a popular demand since the inception of the Community. When harmonisation programme staled, real seat doctrine was considered as a justifiable limitation of the freedom of establishment provided by the TFEU (the then TEC treaty); in order to prevent the unwanted competition between legal orders to happen in the community.[38] However, some legal scholars expressed their concern that the real seat doctrine is incompatible with the treaty provisions on the freedom of establishment because they argued that the provisions imply that a company validly incorporated in a Member State; having its registered office there must be recognised by the other Member States and thus according to the provisions, it should have a right to transfer its effective seat from one Member State to another without losing its legal personality.[39] Major criticism against the real seat doctrine is that it prevents companies from moving from one Member State to another by requiring them to reincorporate in the event it transfers its main office to the host Member State; otherwise the company lose its legal personality and cannot conclude either legally binding contracts or bring legal actions into the courts.[40]

1.3.3 Corporate mobility:

Unlike the United States, in the European Union most of the Member States follow the real seat doctrine and therefore, the possibility of forum shopping and setting up a corporation in the State that offers the most favourable corporate law is very limited in the community. Depending on the country of incorporation, location of central administration of the company and the conflict of laws rules followed by the State incorporated, four types of situation might arise in the Community when a company wants to move its central administration from one State to another and it would be illustrated in the following part of this work. But before diving deep into those situations, a couple of terms regarding corporate mobility need to be defined; which are immigration and emigration. Immigration is the situation that involves the relationship between the host Member State and the incoming company whereas emigration

[37] Birkmose, *A Market for Company Incorporations in the European Union (*n 15)
[38] Gelter, *Centros, the Freedom of Establishment for Companies* (n 30)
[39] Anne Looijestijn-Clearie, Centros LTD - A Complete U-Turn in the Right of Establishment for Companies, 49 Int'l & Comp. L.Q. 621 (2000)
[40] Ulvi ALTINIŞIK, Free Movement of Companies within the EU, (n 13)

covers the relationship between the country of origin and the company moving out of that Member State.[41]

Only a very few countries in the community follow the doctrine of incorporation and though there has been concern about corporate arbitrage regarding this doctrine; it is not in conflict with the freedom of establishment and therefore promotes idea of a Single Market. According to this doctrine the connecting factor is the incorporation itself and consequently the company incorporated in a Member State can locate its central administration in a place other than the State of incorporation. One of the main benefits of this doctrine is its simplicity, especially when a cross border movement of central administration between two Member States that follow the doctrine of incorporation happen. When a cross border movement as such happens and a company moves its central administration to another Member State, the legal status of the company would be unaffected in the host State and it would be recognised as a limited liability company there. So, in the case of immigration where both the States apply the doctrine of incorporation; the company would still enjoy its privilege of limited liability in the host State. On the other hand, if a company incorporated in the doctrine of incorporation State locates its central administration in a Member State that applies the real seat doctrine; the company would be subject to the laws of the receiving State because of the location of the central administration and therefore would lose its legal personality and would not be considered as a limited company owing to the fact of not being incorporated in that particular (receiving) state. In this kind of situation, the company would be treated as a partnership in the receiving state, for example; in Germany and many other countries.[42] However, the outbound situation (emigration) is somewhat controversial which was dealt with in Daily mail.

In contrast, majority of the countries of the European Union adhere to the real seat doctrine and when a company incorporated in such a country transfers its central administration to a Member State that applies the doctrine of incorporation; based on the conflicts of laws rule the company would be considered by the host State as a national of the State where it is incorporated (immigration) and it would be regarded as a legal person of original State by the host state. However, locating the central administration outside of the state of incorporation would result in non-recognition of the legal personality of such a company in the country of origin (emigration situation) because real seat doctrine requires both the place of

[41] Werner F. Ebke, *Centros - Some Realities and Some Mysteries*, 48 Am. J. Comp. L. 623 (2000)
[42] Birkmose, *A Market for Company Incorporations in the European Union* (n 15)

incorporation and the central administration to be in the same place. Thus the consequences what happens to the company in the country of origin would depend on the substantive law of the Member State where it is incorporated and the consequences are not the same in all the Member States. For example; based on the substantive law of Germany, this would result in a compulsory winding up of the company ex lege.[43] On the other hand, in many Member States that apply real seat doctrine; winding up the company is not the consequence, rather in some Member States link the central administration to corporate nationality and the company can only transfer its central administration followed by a change of nationality, for example; Portugal. If the receiving Member State cannot adopt the company by entering it into its own company register under its law, the company would be stateless after the transfer. There are some other Member States where compulsory wind up of the company is not likely to be the consequence, for example; France, Greece, Italy, or Luxembourg.[44]

On the other hand, if the company incorporated in a Member State that applies real seat doctrine and moves its central administration from that State to another State that also applies real seat doctrine; the company would not be validly incorporated in either the state of incorporation or the receiving state and thus would lose its legal personality in both the states.[45]

Therefore, it is apparent that only in one situation when both the home state and host state of a company apply the incorporation state doctrine moves its central administration; the real seat doctrine does not affect its legal status. In all other situations it severely restricts company mobility in the EU one way or the other. Although, the doctrine is criticised for its conflicts with the freedom of establishment granted by the Treaty (TFEU), many Member States felt justified the use of the doctrine assuming that as long as the doctrine would be in use in the EU; it would not be possible for the companies to forum shop and take advantage of the favourable company law regime in the EU and thus an 'European Delaware' would not emerge.

1.4 Early attempts of company law harmonisation:

Legal basis for company law harmonisation comes under Article 50(2)(g) TFEU (ex Article 44(2)(g) TEC) which is ancillary to the rights of free movement for companies, that provides;

[43] Roth, *From Centros to Ueberseering*, (n 36), 9; Birkmose*, A Market for Company Incorporations in the European Union* (n 15)17

[44] Birkmose*, A Market for Company Incorporations in the European Union* (n 15), 18

[45] Birkmose*, A Market for Company Incorporations in the European Union* (n 15), 18

the Council can adopt directives aimed at “coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms … view to making such safeguards equivalent throughout the Union”.[46] In other words, this provision intends to remove the obstacles to the free movement of companies from one Member State to another by bringing some degree of parity or equivalence in the laws that protect shareholders and other range of stakeholder groups which was deemed necessary by the Treaty’s drafters.[47]

Towards the end of the twentieth century when the Community’s company law started to develop, harmonisation of company law was deemed necessary for two reasons. Firstly, in order to achieve freedom of establishment in the internal market it was necessary to have certain level of minimum standards so that shareholders and other stakeholders may rely on it.[48] Safeguards taken by the individual Member States might go beyond and above what is necessary for achieving the goal of equivalence or parity between member states and thus ‘unharmonised national safeguards may make establishment too burdensome or even impossible’.[49] And secondly, since the freedom of establishment also applies to companies; real seat theory would not be as useful as before for Member States for maintaining restrictions on foreign firms provided that they have a registered office, central administration or principle place of business anywhere in the community territory.[50] Consequently, harmonisation of company law in the Community was intended to be used as a mechanism against the ‘race to the bottom’ in the Europe so that a European Delaware does not emerge.[51] According to Clive Schmitthoff, with a view to avoiding the Delaware effect which would erode the standards of shareholder and creditor protection within the EU, it was necessary to have a ‘virtual unification of national company laws’ through harmonisation.[52]

Company law harmonisation in the Community gained its prominence in the late 1960s with the spirit of protective regulation and aim of ensuring freedom of establishment in mind. A step by step harmonisation primarily by directives was taken place in the community and

[46] TFEU, Article 50(2)(g) << http://data.europa.eu/eli/treaty/tfeu_2012/oj >>
[47] Charlotte Villiers, European Company Law: Towards Democracy?, Aldershot: Dartmouth, (1998) 19
[48] Martin Gelter, Centros, the Freedom of Establishment for Companies (n 30) 9
[49] Simon Deakin, Regulatory Competition Versus Harmonisation in European Company Law, ESRC Centre for Business Research, University of Cambridge Working Paper No. 163
[50] Martin Gelter, Centros, the Freedom of Establishment for Companies (n 30) 12
[51] Friedrich Kubler, A Shifting Paradigm of European Company Law, 11 Colum. J. Eur. L. 219 (2005), 5
[52] Schmitthoff, C. (1973) ‘The future of the European company law scene’, in C. Schmitthoff (ed.) The Harmonisation of European Company Law, London: UKNCCL, P9

based on the measures taken for harmonising the company laws; the directives can be divided into four distinct generations.[53] The first generation directives were heavily prescriptive in their nature whereas the second generation directives were more flexible which emphasised on Member State autonomy. Example of first generation directives are the First and Second Directive and the second generation directives are the Fourth, Seventh and Eighth Directive. The third generation directives introduced a new decentralising approach which left many issues to be decided at Member State level; e.g. the Twelfth Directive on single-member private companies (1989). And eventually, fourth generation directives became even more flexible in nature and instead of rigidly prescriptive rules; they were more of general principles or standards in nature. This generation also introduced new techniques for achieving the policy goals by "linking regulatory interventions to the activities and process of autonomous rule-making bodies".[54] Though, it was initially assumed that the company law would be extensively harmonised covering "all provisions concerning structure and organs of companies, formation and maintenance of its capital, the composition of the profit and loss account, the issue of securities, mergers, conversions, liquidations, guarantees required in cases of company concentrations, etc"[55]; in reality this did not happen largely because of the enlargement of the Community which made it harder to reach agreements between Member States due to political reasons. Initially the harmonisation programme was heavily influenced by the German model but after the accession of the UK to the EU (the then European Communities (EC)) in 1973, situation changed and the subsequent directives required more compromise; consequently, the harmonization process of company law within the European Union had not only slowed down, but came to a virtual standstill. Thus Member States were left with only marginal harmonisation when the freedom of establishment of companies started to apply in the community and consequently, in the absence of meaningful harmonisation most Member States continued to adhere to the real seat theory as a justifiable limitation of the freedom of establishment for protecting shareholders as well as other stakeholders.[56]

[53] Charlotte Villiers, *European Company Law: Towards Democracy?* (n 47)

[54] Deakin, *Regulatory Competition Versus Harmonisation in European Company Law*, (n 49) 9

[55] Gelter, *Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law*, (n 30) 13; (quoting from the Berkhouwer report of 1966).

[56] Werner F. Ebke, Centros – Some Realities and Some Mysteries, 48 AM. J. COMP. L. 623, 636 n.83 (2000), at 649 (citing Bernhard Großfeld for the proposition that the real seat theory is condition on the absence of meaningful harmonization)

Chapter 2

2.1 The Queen v. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail[57]:

Facts:

Daily Mail, an investment holding company incorporated under the United Kingdom legislation, intended to transfer its central management and control outside the UK to the Netherlands where Dutch legislation did not prevent foreign companies from establishing their central management there. The company wanted set up a subsidiary or branch in the UK as a foreign company with a view to avoiding substantial capital gain taxes on assets in the UK because the UK foreign companies which have their central management and control outside of the United Kingdom are only taxed on the income arising in the UK and therefore, the Daily Mail intended to sell its asset after the transfer of its residence so that it can avoid the capital gain taxes on assets. In order to transfer the central management and control outside of the UK while maintaining its legal personality and status as a UK company, the consent of the Treasury was necessary according to the UK law. Daily mail applied for the consent but did not wait for receiving it and subsequently opened an investment management office in Netherlands for providing services to third parties. The primary reason behind this proposed transfer was to enable Daily Mail to sell a significant part of its non-permanent assets and use the proceeds of the sale to buy its own share without paying the capital gains tax under the UK law. However, the Treasury denied transfer since it would no longer make the company liable to the UK capital gains tax and Daily Mail challenged the Treasury decision arguing that the requirement to obtain consent which led to the denial constituted to a restriction on its freedom of establishment enshrined in the Articles 52 and 58 of the EEC Treaty (present Article 49 and 54 TFEU). The English court referred the case to ECJ and asked for a preliminary ruling.

4 questions to the ECJ for preliminary ruling; first two questions being the main and the last two are supplementary questions. And the two main questions were: (1) “ … whether Articles 52 and 58 of the Treaty give a company incorporated under the legislation of a Member State and having its registered office there the right to transfer its central management and control

[57] ECJ, Case 81/87 The Queen v. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust [1988] ECR 5483,

to another Member State …"[58]; and (2) "…whether the provisions of Council Directive 73/148 of 21 May 1973 on the abolition of restrictions on movement and residence within the Community for nationals of Member States with regard to establishment and the provision of services give a company a right to transfer its central management and control to another Member State".[59]

Judgment:

The judgement distinguished between the rights granted to natural and legal persons by the EC Treaty which confers the right of primary establishment exclusively to the natural person as opposed to legal person and therefore, the companies only enjoy the freedom of secondary establishment. In doing so the EJC provided its reasoning (autonomy of the national law of the Member State) in the paragraph 19 of the judgment by stating that, "unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law. They exist only by virtue of the varying national legislation which determines their incorporation and functioning".[60]

Further, the ECJ noted that "the legislation of the Member States varies widely in regard to both the factor providing a connection to the national territory required for the incorporation of a company and the question whether a company incorporated under the legislation of a Member State may subsequently modify that connecting factor. Certain States require that not merely the registered office but also the real head office, that is to say the central administration of the company, should be situated on their territory, and the removal of the central administration from that territory thus presupposes the winding-up of the company with all the consequences that winding-up entails in company law and tax law. The legislation of other States permits companies to transfer their central administration to a foreign country but certain of them, such as the United Kingdom, make that right subject to certain restrictions, and the legal consequences of a transfer, particularly in regard to taxation, vary from one Member State to another."[61]

Thus the ECJ answered both the first and second question in negative and held that the Treaty provision did not confer the right to transfer a company's central management and control to

[58] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 11
[59] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 27
[60] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 19
[61] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, Para 20

another Member State while retaining the status of a company incorporated under UK law.[62] With regards to the second preliminary question, which asked whether Directive 73/148 of 21 gave a company the right to transfer its central management and control to another Member State; the Directive only applies to natural person and cannot be applied legal persons.[63]

In the Daily Mail, the ECJ accepted the use of different choice of law in the community by stating in its dicta that "differences in national laws regarding the connecting factors could not be solved on the basis of the Treaty Rules on freedom of establishment".[64] And thus, whether a company could move its seat was dependent on the private international law rules in the state of incorporation. As a result of the use of different choice of law rules, the countries would be able to use the real seat doctrine even though it had an adverse effect on the mobility of the companies in the community by restricting the right of establishment granted by the treaty.[65]

Consequently, the judgement in the Daily Mail was not a major breakthrough for establishing a market for incorporation in the European Union; since the continued use of the real seat theory in the Member State which requires the head office of a company be placed in the registration state would mean that the companies could not forum shop.[66] However, the judgments of the triad namely *Centros*[67], *Überseering*[68] and *Inspire Art*[69] came as a surprise which opened the door to regulatory competition in the European Union.

2.2 Centros Ltd v Erhvervs- og Selskabsstyrelsen[70]:

Facts:

A Danish couple; Mr. and Mrs. Bryde bought an English private limited liability company and applied to the Erhvervs- og Selskabsstyrelsen (Danish Trade and Companies Board, "the Board")[71] to register a branch in Denmark.[72] The couple decided to do that because of

[62] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 24.
[63] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 28
[64] ECJ, Case 81/87, ex parte Daily Mail [1988] ECR 5483, para 23
[65] Birkmose, A Market for Company Incorporations in the European Union (n 15) 22
[66] Birkmose, A Market for Company Incorporations in the European Union (n 15) 22
[67] ECJ Case C-212/97 of 9 March 1999, ECR 1999, 1-1459. (Centros)
[68] ECJ Case C-208/00 of 5 November 2002, ECR 2000, 1-9919. (Überseering)
[69] ECJ Case C-167/01 of 30 September 2003, in: DB 2003, 2219. (Inspire Art)
[70] ECJ Case C-212/97, (Centros)
[71] Erhvervs- og Selskabsstyrelsen is the administrative body responsible for the incorporation and registration of companies in Denmark.

Denmark's heavy burden of capital requirements for the formation of closely-held limited liability corporation where it required a fixed minimum capital of DKr 200,000 Danish Krone whereas in the UK the minimum capital requirement for setting up a company was only £100 pounds. The agency refused to register the branch on the grounds that, it did not trade in the UK and rather than establishing a branch; Centros Ltd. was trying to set up a primary establishment in Denmark by circumventing the minimum capital requirement required by the national Act No. 886 of 21 December 1991.

Centros Ltd. appealed the decision of the Danish Administration arguing that pursuant to Articles 52 and 58 TEU (present Articles 49 TFEU and 54 TFEU); as a lawfully incorporated company, it was entitled to establish a branch in Denmark. The Danish administration's decision was upheld by the Danish Courts and as a result the case subsequently moved to the Danish Supreme Court which decided to stay proceeding and asked the ECJ for a preliminary ruling on the interpretation of Articles 52, 56 and 58 TEU (present Articles 49, 52 and 54 TFEU).

The question referred to the ECJ was as follows:

"is it contrary to Articles 52 and 58 of the Treaty for a Member State to refuse to register a branch of a company formed in accordance with the legislation of another Member State in which it has its registered office but where it does not carry on any business when the purpose of the branch is to enable the company concerned to carry on its entire business in the State in which the branch is to be set up, while avoiding the formation of a company in that State, thus evading application of the rules governing the formation of companies which are, in that State, more restrictive so far as minimum paid-up capital is concerned".[73]

Judgment:

"it is contrary to Articles 52 and 58... to refuse to register a branch of a company formed in accordance with the law of another Member State in which it has its registered office but carries on no business ....”[74] It also added that, this interpretation does not prevent the authorities of the (host state) to adopt appropriate measures for preventing or penalising fraud, either in relation to the company itself, or in relation to its members, where it has been established that they are in fact attempting by means of the formation of a company, to evade

[72] ECJ Case C-212/97 (Centros)
[73] Ibid para 14
[74] Ibid para 39.

their obligations towards private or public creditors established in the territory of the Member States concerned".[75]

2.3 Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)[76]:

Facts:

Überseering BV, a Dutch corporation registered in the Netherlands in 1990 which acquired a piece of land in Düsseldorf (Germany) that included a garage and a motel.[77] In 1992, *Uberseering BV* engaged *Nordic Construction Company Baumanagement GmbH (NCC)* to refurbish the property that was acquired in Düsseldorf. The refurbishment was carried out by *NCC* but upon completion of the work, *Überseering* claimed that the work was defective and brought an action before the Regional Court (Landgericht) in 1996 against *NCC* on the basis of the contract seeking compensation for the alleged defect. However, in 1994 before the proceeding started, all the shares of *Überseering* were acquired by two German citizen residing in Düsseldorf and since Germany follows the real seat doctrine as the conflicts of law rule (principle) for determining the applicable law, the Court came to the conclusion that German law had to be applied because *Überseering* had transferred its actual centre of administration to German and thus dismissed the action. Subsequently the Higher Regional Court (Oberlandesgericht) upheld the decision from the Regional Court on the basis that German law would be applied in this situation since the central administration been transferred to Germany once the shares of the company has been acquired by the two German nationals and thus according to the German Code of Civil Procedure, a party must have legal capacity to be able to sue another party which the company did not have because of its being incorporated in the Netherlands and would have needed to be reincorporated in Germany to have the legal capacity under German law for bringing the damage action in German Courts. *Überseering BV* appealed to the Federal Court of Justice (Bundesgerichtshof, the German Supreme Court) which decided to stay proceedings and to refer the following questions to the Court for a preliminary ruling:

---

[75] Ibid para 39

[76] (2002) C-208/00, [2002] ECR I-9919, Überseering BV v Nordic Construction Company Baumanagement GmbH (NCC)

[77] Ibid (n 76)

"1. Are Articles 43 EC and 48 EC to be interpreted as meaning that the freedom of establishment of companies precludes the legal capacity, and capacity to be a party to legal proceedings, of a company validly incorporated under the law of one Member State from being determined according to the law of another State to which the company has moved its actual centre of administration, where, under the law of that second State, the company may no longer bring legal proceedings there in respect of claims under a contract?

2. If the Court's answer to that question is affirmative:

Does the freedom of establishment of companies (Articles 43 EC and 48 EC) require that a company's legal capacity and capacity to be a party to legal proceedings is to be determined according to the law of the State where the company is incorporated?"[78]

Judgment:

Initially the Court examined whether the Treaty provisions on freedom of establishment applied to the case and found that, " … where a company which is validly incorporated in one Member State ('A') in which it has its registered office is deemed, under the law of a second Member State ('B'), to have moved its actual centre of administration to Member State B following the transfer of all its shares to nationals of that State residing there, the rules which Member State B applies to that company do not, as Community law now stands, fall outside the scope of the Community provisions on freedom of establishment."[79]

In its judgment the ECJ stressed that freedom of establishment conferred by Article 43 EC (present Article 49 TFEU) entitled Community nationals " …to set up and manage undertakings under the same conditions as are laid down by the law of the Member State of establishment for its own nationals."[80] Additionally, the Court mentioned Article 48 of the EC Treaty (present 54 TFEU) in its judgement which states; "companies or firms formed in accordance with the law of a Member State … shall be treated the same way as natural persons".[81]

After that the ECJ distinguished between the Daily Mail and the present case where in Daily Mail the issue at stake was between a company and the home state of incorporation;

[78] Überseering [2002] ECR I-9919, para 21.
[79] Ibid para 52
[80] Ibid para 56
[81] Ibid para 56

conversely, the present case concerned the recognition by a host Member State of a company formed in accordance with the law of a Member State that transferred its central administration to the host Member State's territory.[82] Thus, based on this reasoning the ECJ rejected the argument that the judgment in *Daily Mail* suggested *Überseering* case fell outside the scope of the Treaty provisions on freedom of establishment; rather the ECJ decided that *Überseering* did not fall outside the scope of the Treaty provisions on freedom of establishment and the question of recognition of a company's legal capacity and its capacity to be a party to legal proceedings had to be considered in relation to the scope of the Treaty provisions on freedom of establishment. Consequently, the ECJ found that the German Court's refusal to recognise *Überseering BV's* legal capacity and capacity to be party to legal proceedings constituted a restriction on the freedom of establishment. Therefore, it means that the denial of the company's legal capacity by the immigrating Member State (inbound situation) was incompatible with the free movement of establishment.

2.4 Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art Ltd[83]:

Facts:

Inspire Art Ltd., a private company limited by shares established in the United Kingdom and had its statutory seat in Folkestone. The company which was dealing in objects d'art, never traded in the UK and just right after its formation, started doing business in the Netherlands. The main intention of the shareholder in registering the company in the UK was to take advantage of the liberal rules of the British company law. The company registered a branch in Amsterdam where the Wet op de Formeel Buitenlandse Vennootschappen (WFBV) (Dutch law on pseudo foreign companies) required *Inspire Art* to indicate that it was a pseudo-foreign company upon registration which the company did not comply with. The Amsterdam Chamber of Commerce applied to the competent court for an order that the company complete its registration according to the Article 1 WFBV by indicting it as "pseudo-foreign company". As a pseudo-foreign company, it would have to comply with Article 2 to 5 WFBV; which impose numerous further disclosure requirements and a minimum capital requirement. This minimum capital requirement; which required the company's subscribed

[82] [2002] ECR I-9919, Überseering , para 62
[83] Case C-167/01; ECR [2003] 00000, Kamer van Koophandel en Fabrieken voor Amsterdam v.Inspire Art Ltd

capital to be equal to the minimum amount required by Article 178 of Dutch Civil Code (Burgerlijk Wetboek), if not complied with; the directors of the company would be jointly and severally liable for the debts of the company. The Amsterdam district court (Kantongerecht Amsterdam) held that *Inspire Art Ltd*., was a pseudo-foreign company within the meaning of Article 1 WFBV and referred the following questions to the ECJ for a preliminary ruling:

"1. Are Articles 43 EC and 48 EC to be interpreted as precluding the Netherlands, pursuant to the Wet op de formeel buitenlandse vennootschappen of 17 December 1997, from attaching additional conditions, such as those laid down in Articles 2 to 5 of that law, to the establishment in the Netherlands of a branch of a company which has been set up in the United Kingdom with the sole aim of securing the advantages which that offers compared to incorporation under Netherlands law, given that Netherlands law imposes stricter rules than those applying in the United Kingdom with regard to the setting-up of companies and payment for shares, and given that the Netherlands law infers that aim from the fact that the company carries on its activities entirely or almost entirely in the Netherlands and, furthermore, does not have any real connection with the State in which the law under which it was formed applies?

2. If, on a proper construction of those articles, it is held that the provisions of the Wet op de formeel buitenlandse vennootschappen are incompatible with them, must Article 46 EC be interpreted as meaning that the said Articles 43 EC and 48 EC do not affect the applicability of the Netherlands rules laid down in that law, on the ground that the provisions in question are justified for the reasons stated by the Netherlands legislature?"[84]

Judgement:

The ECJ decided in favour of freedom of establishment and found the disclosure requirement as a pseudo-foreign company in breach of 11th directive[85]. Concerning the second question the ECJ referred to its earlier judicature and held the except for cases involving fraud,[86] "it was immaterial for the applicability of the freedom of establishment that a company had been

[84] ECJ Case C-167/01 Inspire Art Ltd, para 39.
[85] Directive 89/666/EWG of 22 December 1989, Official Journal L 395/36; amended by DIRECTIVE (EU) 2017/1132 relating to certain aspects of company law
[86] ECJ Case C-212/97, Centros Ltd, para 24.

set up in a certain Member State with the sole aim of establishing itself in a another Member State, where its main, or indeed entire, business was to be conducted".[87]

Chapter 3

3.1 Legal Forum Shopping becomes good practice after *Centros*:

By answering the question; whether *Centros*[88] could rely on the freedom of establishment and whether the restriction by the Danish Authority towards it could be justified, the ECJ established that it is completely a good practice for a national to set up a company in a Member State where the law seems to be the least restrictive and build a branch in another Member State to do business there and this mere act would not constitute an abuse of freedom establishment.[89] "On the contrary, this practice was considered to be inherent in the exercise of the freedom of establishment".[90] "According to the ECJ, the relevant Treaty provisions are intended to enable companies to have their central place in one Member State and to pursue business activities through forms of secondary establishment in other Member States".[91] The Court also clarified its position by providing reference to the established case law *Segers*[92] that, it is possible for the host country to restrict the abusive behaviour but in the present case the mere fact that the company did not conduct any business in the State of incorporation was not sufficient to prove any existence of abuse or fraudulent conduct.[93] One of the most important developments of *Centros* is that; whereas in *Daily Mail* the absence of legislative harmonisation was used not to apply Article 49 TFEU, in *Centros* the absence of Community harmonisation was regarded irrelevant[94] and in doing so, the ECJ shows its willingness to remove the last restrictions on the free movement of companies in the

[87] Christian Kersting; Clemens Philipp Schindler, The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice, 4 German L.J. 1277 (2003), 6.
[88] ECJ Case C-212/97, (Centros)
[89] Henrik Norinder, *The aftermath of Inspire Art-Applicability of the real seat theory and grounds for justification*, University of Lund (Master's thesis).
[90] Ibid 89
[91] Ibid 89
[92] C-79/85, D. H. M. Segers v. Bestuur van de Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen, [1986] ECR I-02375)
[93] Case C-212/97, Centros, para 29; C-79/85, Segers, para 16.
[94] Case C-212/97, Centros, para 28.

Community.[95] "Furthermore, the ruling was said to be intended to complete the internal market by allowing competition among national rules".[96]

3.2 Implications of Centros and Inspire Art on Real Seat Doctrine

Centros[97], *Überseering*[98] and *Inspire*[99], this triad has a strong impact on real seat doctrine. After these judgments, many scholars have declared this doctrine dead.[100] Though, nowhere in these judgments the Court can be found in favour or in denial of the real seat theory.[101] Surely these judgments have curtailed the Member States' ability to impose restrictions on immigrating companies that applies to both the real seat and incorporation theory States. Therefore, the impact of these judgments on the real seat doctrine needs careful consideration.

After the Centros judgment many scholars saw the end of real seat theory coming,[102] especially because of the Court's explicit declaration that setting up a firm in one Member State and branches in another in itself does not constitute an abuse of the Treaty provisions.[103] As the Court took the valid formation of the company in the UK as a decisive factor in this case by disregarding the real seat in Denmark, many scholars argued that this was a clear indication of the Court's tendency towards the incorporation theory.[104] Several scholars and judicial bodies have taken a stand against this view and opposed that, the decision in the case concerned a Member State subscribed to incorporation theory and therefore, could not affect real seat theory. They also argued that, as an incorporation theory state, Denmark's requirement of proof of a genuine link to the home country for registering a branch office should not be confused with real seat theory.[105] Furthermore, proponent of this

---

[95] Henrik Norinder, *The aftermath of Inspire Art-Applicability of the real seat theory and grounds for justification*, (n 88) 14.
[96] Ibid 95
[97] ECJ Case C-212/97 (Centros)
[98] ECJ Case C-208/00 (Überseering).
[99] Case C-167/01. (Inspire Art)
[100] Birkmose, *A Market for Company Incorporations in the European Union (*n 15)
[101] Henrik Norinder, *The aftermath of Inspire Art-Applicability of the real seat theory and grounds for justification*, (n 88)
[102] Martin Gelter, Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law (February 13, 2015) (n 30)
[103] Centros, para 27.
[104] Ibid 102, 24.
[105] Erik Werlauff, The Main Seat Criterion in New Disguise – An Acceptable Version of the Classic Main Seat Criterion, 2001 EUR. BUS. L. REV. 2, 3 (explaining that Danish law applies the incorporation theory with a "genuine link" criterion).

view argued that like the *Daily Mail;* the case left the conflict of law rules regarding the recognition of foreign companies intact[106] by stating in the judgment that "the Treaty regards the differences in national legislation concerning the required connecting factor ... as problems which are not resolved by the rules concerning the right of establishment."[107]

"Given the discussion whether *Centros* applied only in incorporation theory countries or only to secondary establishments, the death knell for the real seat theory only came with the *Überseering* case of 2002".[108] In *Überseering* the Court dealt with this situation where two German nationals acquired the shares of the company which was incorporated in the Netherlands. Upon acquisition of the shares, the company was led to conduct all of its business in Germany. A strict interpretation of the real seat theory by the German Court would lead to a denial of legal entity of *Überseering BV* but in preliminary ruling of case the ECJ decided that a company validly formed under the jurisdiction of a Member State which was simply exercising its freedom of establishment had to be also acknowledged in another Member State which follows real seat theory. Thus the duty of recognition was established; which applies both to a company that wants to set up a secondary establishment and transfer central administration in another member state.[109] The judgment in *Daily Mail* can be distinguished from the judgment in *Centros* and *Überseering*; while the *Daily Mail* case is concerned with the relationship between companies and their state of incorporation, the *Centros* and *Überseering* dealt with the restrictions on the company's freedom of establishment by another Member State,[110] leaving no conflicts among these judgments.[111] "After *Überseering*, the zombie idea that the freedom of establishment did not apply in real seat countries quickly disappeared from the pages of legal journals."[112] However, real seat doctrine is still applicable in a number of cases, they are; internal matters that is not related to company law, such as insolvency or tax law, when its applied for the protection of public interest and last but not least to the companies that are not covered by the Treaty, for instance; non-profit organisation and foreign companies.[113] Though many writers have declared the death of real seat theory; taking both the *Centros* and *Überseering* judgments

[106] Martin Gelter, Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law (February 13, 2015) (n30)

[107] Ibid 106; Centros, para 23.
[108] Ibid 106
[109] Birkmose, *A Market for Company Incorporations in the European Union (*n 15)
[110] Überseering, para 62.
[111] Ibid 106
[112] Ibid 106, p24.
[113] Ibid 109, p46

into consideration, it can be concluded that the real seat theory has lost its importance to a large extent but by no means dead.

Finally, *Inspire Art* involves a minimum capital requirement imposed by Dutch law on a company incorporated in the United Kingdom which intended to carry out business in Netherlands. The Dutch minimum capital requirements along with a number of other restrictions were imposed on the company when it wanted to set up a branch in the Netherlands. The Dutch law restrictions were intended to provide protection against the intrusion of the foreign companies deliberately avoiding Dutch law.[114] The ECJ found that the Dutch law violated the freedom of establishment and tried to justify the restriction on both Article 52 TFEU (former Article 46 EC) and ground of overriding public interest by applying *Gebhard* criteria and could not justify it. However, the Court acknowledged that Member States may implement measures against fraud.[115]

3.3 The Market for Company Incorporations:

As mentioned earlier that legal forum shopping became a good practice after the *Centros* judgment. Though *Inspire Art* neither expanded companies' ability to forum shop nor the area of corporate mobility, it has emphasised that forum shopping is the consequence of freedom of establishment. Therefore, its implication on the market for company incorporation seems to be limited as it's only confirming corporate mobility established in *Centros* and *Überseering*. One of the most important thing, *Inspire Art* established that not only national conflicts of rules but also other national company law rules applied to pseudo-foreign companies covered by Article 49 TFEU and Article 54 TFEU (ex Articles 43 TEC and 48 TEC) can constitute a restriction on freedom of establishment unless it can be justified on the grounds of Article 52 TEEU (ex Article 46 TEC) or overriding public interest.[116] However, the Court did not shed any light by providing guidelines on the circumstances under which restriction on freedom of establishment would be justifiable on public interest grounds. Thus, it cannot be concluded from the ruling on *Inspire Art* that it would be impossible for national

[114] Martin Gelter, Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law (February 13, 2015) (n30)
[115] Inspire Art, para 136.
[116] Birkmose, *A Market for Company Incorporations in the European Union (*n 15), 53

company law to require pseudo-foreign companies to satisfy certain additional requirements.[117]

Empirical research after a few years of the judgment shows that, "after *Inspire Art* the number of incorporations of private limited liability companies in the UK with the apparent objective of doing business in Continental European countries skyrocketed."[118] The demand for English limited companies in Germany was particularly strong because of its relatively easy procedure for setting up a company and in addition to that service provided by private agencies over the internet that took care of the formalities, favoured the English law over the German law. However, this was not the case for all the countries in Europe. Nevertheless, English limited companies turned into the most attractive one and by far the most common across the continent.[119] Consequently, regulatory competition became a hot topic in the pan-European legal scholarship where two schools of thoughts try to analyze the prospect of the dominance of destructive race to the bottom or race to the top in the future.[120]

3.4 Practical consequences of *Centros* and *Überseering*:

The development in the recent EU Company Law by the ECJ judgments in *Centros* and *Überseering* opened the possibility of market for company incorporation. It was not possible for companies to forum shop until these two decisions which established the conditions for a market for company incorporations, although it's not perfect, it has brought the EU a great deal closer to the situation in the USA. In order for such a competition between legal systems to arise, the establishment of a market where the Member State as well as companies will participate is a precondition. Many scholars believe that "European Union is far from having established a market for company incorporations that can be compared to the U.S. market" because the market that has been established after these judgments is only partial and not yet complete because of the continued use of real seat doctrine and lack of access to reincorporation.[121] The continued used of real seat doctrine in the community means that Member States that apply the doctrine would not be able to be part of the competition for company incorporation. Again, regulatory competition in the EU will require more than just

[117] The additional requirements must, of course, satisfy the four conditions referred to in InspireArt, paragraph 133. See InspireAr4 2003 E.C.R. 1-10155 para. 133.
[118] Martin Gelter, Centros, the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law (February 13, 2015) (n 30) 26
[119] Ibid 118
[120] Ibid 118, p27
[121] Birkmose, *A Market for Company Incorporations in the European Union (*n 15) 53

the creation of the market. It will not only require some effort from the Member States to attract as many incorporations as possible by making their company laws more attractive but also will require the willingness of the companies to forum shop the most attractive company law and migrate to that Member State.[122] Like any other market the general economic principle of supply and demand can be applied to the market for company incorporations where states' are on the supply side and companies are on the demand side and since these judgments did not establish the right to reincorporate companies in the EU, Member States would only be able to compete for attracting company incorporations. Thus the Member States would have to keep in mind about the certain characteristics of the company law that benefits (favourable to) the company promoters as they are the actual decision maker for incorporation of a company. Both of those who are supplying and demanding the laws would try to maximize their interests and next section will try identifying Member States' incentives for competing on company incorporation namely the financial incentives.

Chapter 4

4.1 State's Financial Incentive/ State's Incentive to Compete:

A state that is willing to generate revenue from company incorporation and benefit financially would have to frame the company law in a way so that it can attract large number of new incorporation while retaining existing companies that have already been incorporated and thus maximise its financial interest. As the promoters of the companies, who are the real decision makers of the company for incorporation, are interested in maximizing their financial interests, it is likely that they will conduct cost benefit analysis for ensuring that the benefits gained from the incorporation is more than the cost of forum shopping and thus the benefits outweigh the costs. On the other hand, the revenue received by a state must exceed the costs of providing services for the incorporating companies in that state and thus generate a net yield which will provide the state with the financial incentive to compete to attract company incorporations.[123] The financial incentives for generating revenue for the state can be direct and indirect where direct financial incentives are those that generate revenue directly from incorporated companies through taxes, duties and fees. On the other hand, states can have indirectly incentives for generating revenue from levying taxes on different interest

[122]Birkmose, *A Market for Company Incorporations in the European Union (*n 15) 53
[123] Ibid 122, 25

groups (for example lawyers, accountants and other advisors) that offer services to those incorporated companies.

4.1.1 Direct Financial Incentives for the States in the USA and the European Union:

Scholars from different parts of the world had assumed that direct financial incentives played an important role in the U.S. for establishing a market for company incorporation especially because of the possibility of collecting *franchise tax*. Franchise tax is a tax charged by the state of incorporation that is based on "the number of shares of authorized capital stock (whether or not issued) of the corporation or an amount based on the assumed no-par value capital plus the assumed par value capital of the corporation".[124] It gives the states an opportunity to earn revenue even if the company does not operate in the place where it is registered because the tax is not dependent on the activities of the company. In the USA, the state of Delaware dominates the market for company incorporation and in 2019, it collected a little over $906 million revenue from franchise tax which amounts to 19.7% of the total revenue.[125] However, doubt remains whether franchise tax plays the most important role as financial incentive for other states in the USA; since it only consists a small part of their total budget.[126] The scenario is the complete opposite in the European counterparts; because unlike USA it's not possible to impose franchise tax in the European Member States and therefore, Member States do not have sufficient incentive to compete for company incorporations. Karsten Sorensen and Mette Neville have pointed out: "[T]here are no fiscal advantages of becoming the Delaware of the European Union. The main reason for the competition among states in the USA was the potential for increased tax revenue; in the EU, we do not impose an annual franchise tax and therefore, the motivation of the individual Member States for attracting corporations is not as high…"[127] Again, Directive on indirect taxes on the raising of capital regulates the Member States' income derived from company incorporation.[128] Member States are only allowed to collect capital duty upon the incorporation of a company

---

[124] R. Franklin Balotti and Jesse A. Finkelstein, Delaware. Law of Corporations & Business Organizations (Aspen Law & Business, 1999), 18-10.

[125] https://financefiles.delaware.gov/Fiscal_Notebook/2019/2019-Fiscal-Notebook-FINAL.pdf

[126] Hanne Sondergaard Birkmose, A Race to the Bottom in the EU, Maastricht Journal of European and Comparative Law March 2006, Vol.13(1), pp.35-80, 60

[127] Karsten Engsig Sorensen & Mette Neville, Corporate Migration in the European Union: An Analysis of the Proposed Fourteenth EC Company Law Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law, 6 Colum. J. Eur. L. 181, 186 (2000), at 208.

[128] Consolidated Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes on the raising of capital which repealed Council Directive 69/335/EEC 1969 O.J. (L 249/25).

provided that such duty does not exceed the actual cost of handling and registration of company.[129] Additionally, under the directive it is not permitted for the Member States to levy a tax more than one percent of the value of the shares on the formation of a capital company or an increase in capital.[130] Again, a company is only taxable at the place where its central administration is situated[131] and thus a company having registered office in one Member State and central administration in another; pays tax only in the later state. Therefore, it is unlikely that the capital duty would be the direct financial incentive for regulatory competition in the European Union.[132] The European Court of Justice (ECJ) has interpreted the Directive in a number of cases that helps understanding the extent to which Member State can tax or collect fees from incorporated companies. *Ponente Carni*[133]was concerned with registration charges levied by the Italian government and the ECJ held that "individual taxes, displaying the same features as capital investment tax, also fall within the scope of Article 10 of the Directive. Thus, Article 10 applies to any form of tax levied in connection with the formation of a company, its registration or any other formality required before the commencement of business and to which a company may be subject by reason of its legal form."[134] Again, in *Herta Schmid*[135] the ECJ held that the levying a minimum tax on capital companies did not fall within the scope of Article 10 and thus it established that the Directive does not prevent Member States from levying a minimum corporation tax, even in situation where a company has not had any income at all in that year. Again, this minimum corporation tax would not likely be an incentive for incorporation state to compete for incorporations because of the double taxation agreement. And finally, in *Manifattura italiana Nonwoven*[136] it was established that levying tax on a company's net assets annually at the end of the financial year was not a capital duty or did not have the characteristics as a capital duty and therefore, was not prevented by the directive. Additionally, according to Article 2(1)

[129] Council Directive 2008/7/EC, article 6(1) (e); which repealed Council Directive 69/335/EEC 1969 O.J. (L 249/25), article 12(1)(e).
[130] Council Directive 2008/7/EC, article 8(3) ; which repealed Council Directive 69/335/EEC 1969 O.J. (L 249/25).,arts. 4(1), 7.
[131] Council Directive 2008/7/EC, Article 10(1), 10(2); which repealed Council Directive 69/335/EEC 1969 O.J. (L 249/25),art. 2(l).
[132] Birkmose, *A Market for Company Incorporations in the European Union (*n 15) 54
[133] Joined cases C-71/91 and C-178/91, Ponente Carni, [1993] ECR I-1915.
[134] Birkmose, A Race to the Bottom in the EU (n 126) 27
[135] Cf. Case C-113/99, Herta Schmid, [2001] ECR I-471.
[136] Cf. Case C-4/97, Manifattura italiana Nonwoven, [1998] ECR I-6469. paragraphs 22, 23 and 24.

of the OECD's Model Agreement[137]; a tax on a company's net asset falls outside the scope of double taxation agreement, since these agreements only cover income and capital taxes and thus "Member States might have a financial incentive if they levy a tax on the incorporated companies' net assets, which is a tax independent of the location of the principal place of business of the company or its head office."[138]

Though the Directive concerning indirect taxes on raising of capital affects the extent of Member States financial incentive to attract a large number of incorporations, certain areas are not covered by it which although limited in nature, can give Member States some financial incentive to compete for incorporations. However, doubt remains whether the revenue received would be sufficient financial incentive for the Member States to compete for company incorporations. Moreover, such a tax is most unlikely to be introduced in the EU partly because it would not only affect the newly incorporated companies but also the companies already incorporated and would most certainly meet resistance from the local business community.[139]

4.1.2 Indirect Financial Incentives:

Except for direct taxation, Member States will certainly experience some other economic benefits indirectly flowing from a large number of company incorporation and thus the legislators would adopt company law that is likely to maximize the number of companies incorporated. In addition to the cost of incorporation, companies have other costs connected to the incorporation. Professional advisors who provide services to the companies gain financial benefit directly from a large number of incorporations. When a company incorporates in a Member State, it seeks advice from different professional advisors; e.g. lawyers, accountants and other advisers and payment made to them have downstream effects which will be source of indirect income for the Member State. A large number of company incorporations will generate more income for these interest groups and the state of incorporation will in turn be benefited from is financially because it will receive a share of this money in the form of taxes. Therefore, if all or most of the service providers are domiciled in a specific country, it would be able to maximize its revenue from the service

[137] Model Tax Convention on Income and on Capital: Condensed Version 2017 , available << https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page30>>, Article 2(2) defines income tax and capital tax.
[138] Birkmose, A Race to the Bottom in the EU (n 126) 28
[139] Birkmose, A Race to the Bottom in the EU (n 126), 26, 28

providers by maximising the number of incorporations.[140] Again, there might be some other interest groups that are likely to benefit from the large number of company incorporation and could lobby the Member State for regulatory competition. Therefore, that it is hard to predict what could be the incentive for a Member State for regulatory competition.

4.1.3 Setting the price for incorporation when the state is maximising value:

As mentioned earlier that the general economic principles can also be applied to the market for company incorporations where the state is the supplier of the product namely company law. Since legislators are the decision makers of the state, they can set the total price of the incorporation and make it more or less expensive depending on the state's goal. The price of a product depends on various things including the demand, supply, the nature of the market and the short and long term goal of the supplier etc. In a perfectly competitive market, the firms are price taker and cannot influence the market price and thus in a perfectly competitive market, the state cannot set the price of incorporation above the market price. However, in the real world the states operate in an imperfect market which in fact a monopolistic market and thus the state can set the price for incorporation above the market price.[141] "The difference between the price which states actually demand and the price they could demand in a situation with perfect competition is called rent."[142]

Again as discussed earlier that the state of incorporation has both direct and indirect financial incentives for company incorporation, so it can be said that the price for incorporation consists of direct and indirect cost for the companies where direct costs are paid by the companies in the form of taxes, duties and other fees to the state; on the other hand, indirect costs are costs paid by the companies as a consequence of incorporation usually when they seek professional advices. The proportion of the direct and indirect cost to the company matters to the state because a wealth maximizing state fully benefits from the direct part of the price, since the money directly goes to the treasury and the state is free to dispose it as it feels right. However, a state cannot act itself and depends on the legislature for fulfilling its goal which comes with agency problem. Since the state promotes the interests of its citizen, it is generally assumed that when a state wants to maximize its revenue from company

[140] Birkmose, A Race to the Bottom in the EU (n 126) 28-29
[141] Henry N. Butler, 'Corporation-specific Anti-takeover Statutes and the Market for Corporate Charters' Wisconsin Law Review 365 (1988), 377; and Kahan and Kamar, 'The Myth of State Competition in Corporate Law', 687-693.
[142] Birkmose, A Race to the Bottom in the EU (n 126) 29

incorporation, the legislature shares the same interest because they are the elected representative of the citizen. But this not the case in real life because legislators might be more interested in maximizing their personal interests rather than the state's interest which can be evident from their failure to maximise the direct part of the price for incorporation allowing the indirect part of the price to be a substantial part of it.[143]

4.2 Incentive for Companies to Forum Shop:

In the race debate it is assumed that companies will incorporate in a jurisdiction where its interests are best served. Company as a legal person depends on a number of individuals for its day to day activities who manage and control the company on a daily basis. As long as the company's best interests are served this principle agent relationship is not a problem at all but in real life this is not the case and like most of the principle agent relationship this one comes with a cost too; instead of serving the company's best interest by incorporating in a jurisdiction that offers the most advantageous law for it, in many cases the agents choose to incorporate or reincorporate in a jurisdiction that protects and serves their personal interests the best. Therefore, it is important to consider whether the companies will have sufficient incentives to forum shop along with who the real decision maker is and decide where to incorporate or reincorporate the company. In order to know the incentives of the companies and what influences the decision makers' choice, we have to turn to the theories of law and economics. Based on the neoclassical economics; law and economics assumes that the rationale behind any decision or choice of an economic actor is to maximisation their personal welfare and companies are not an exception to this who strive to maximize their wealth.[144] Thus the shareholders would be interested in maximizing the company's wealth to maximise their personal financial interests in the company by forum shopping. The next will discuss the shareholders', who are the investors or promoters of a company, incentives for forum shopping on the initial incorporation of a company. As it is already mentioned that, there is a separation of ownership and control and since the management rather than the shareholders run the company on a daily basis, they will be interested in maximising their personal welfare as well. The section after next will identify who the real decision maker for re-incorporation and what are the incentives that they might have for forum shopping.

[143] Birkmose, A Race to the Bottom in the EU (n 126) 29-30
[144] Ibid 143, 8

4.2.1 Initial incorporation and the company promoters' incentive to forum shop:

Promoters invest time and money for setting up companies and consequently, take the initial decision of incorporation. According to the theory of law and economics they would like to maximize their personal welfare that is maximization of their personal wealth which will ultimately affect their incorporation decision. Since they would like to maximise their personal wealth as well as the company's wealth, they will look for jurisdiction that will help them pursuing their personal interests. If a foreign jurisdiction gives the promoters certain advantage over their home state company law and if the net benefit of incorporation is higher than the net cost, this will give the company promoters the incentive to choose the foreign company law over their own company law and thus incorporate in that jurisdiction. Therefore, if there are substantial differences between home state company law and other state company law and if the differences relate to the area that the promoters have personal interests, it is likely that the promoters will have the incentive to forum shop. For example, the promoters might emphasis on the provision of quick and cheap incorporation services and make their incorporation decision based on that which actually happened in the case of incorporation in the UK where a large number of Dutch citizens incorporated their companies rather than incorporating in the Netherlands.[145] Again, capital requirements can play a vital role for initial incorporation which might give the company promoters the incentive to forum shop. This was the case with *Centros*[146] where the promoters wished to circumvent the Danish minimum capital requirement rule and established the company in the UK.

4.2.2 Incentives for the promoters to forum shop with continued interests in the company in mind:

Once the company has been incorporated, the role of the promoters change and in most cases they are likely to have a continued relationship with the company either as a shareholder or a member of the management that might as well give them some incentive to forum shop. If the promoters subscribe for the shares in the company; which they most likely are, they will emphasise on the provisions regarding shareholders' right during incorporating the company and will look for a company law that serves their interests the best. Although, the situation is not as straight forward; since the incentive depends on what kind of interests the promoters

[145] Birkmose, A Race to the Bottom in the EU (n 126) 9
[146] ECJ Case C-212/97 of 9 March 1999, ECR 1999, 1-1459. (Centros)

have in the company as shareholders which includes among other things their percentage of shareholding in the company.

If promoters as shareholders of the company have only pure financial interests, they will be interested in maximizing their portion of financial gains and since the shareholders' financial gains is a function of the company's financial gains; therefore, they will look around to choose the most advantageous company law that will maximize the company's profit and thus will maximise the return on investment for themselves as well as for other shareholders.[147]

It is not only the financial interests that might influence the choice of incorporation state but also the non-financial interests that might influence it and depending on the percentage of the shareholding; the promoters' incentive might change which will affect their choice of incorporation. In the situation where a majority of the shares are expected to be held by the promoters, it is highly likely that they will seek for a company law that will let them control the company by means of influencing the management.[148] In order to gain control of a company most countries require a shareholder to own a majority of the issued shares which is more than 50% of the shares. Additionally, the shareholder who has majority of the shares; depending on the margin of his majority might be able to influence important company decision for example the amendment of the articles of association. However, if the promoters wish to be majority shareholders, they will seek a company law that provides them the possibility of controlling the company without hindrance from the minority shareholders, for example; provisions regarding transferability of shares, prohibition relating to ownership ceiling, prohibition relating to voting ceiling etc are important from the majority shareholders' perspective and they will choose the company law that gives them the best possible way to control the company. Therefore, it is likely that they will choose a company law that will not give strong minority protection so that majority shareholders' powers are not restricted.[149]

Conversely, if the promoters expect to hold only a small number of shares in the company, their incentive to choose the incorporation jurisdiction will change and they will more likely to choose a company law that will protect their interests. Therefore, the promoters will emphasise on the provisions on minority shareholders' protection because of the risk of

[147] Birkmose, A Race to the Bottom in the EU (n 126) 10
[148] Ibid 147, 10
[149] Ibid 147, 11

another shareholder acquiring a majority of the shares and undermining their interests. Provisions that aim to protect the minority shareholders might be stringent, for example; it might require a super-majority in order to amend the articles of association, it might also provide certain rights such as the right to attend the general meeting and vote, the right to obtain certain information about the company as well as asking questions of the management at the general meeting. “Another area of minority protection that has been discussed in recent years is the right to sue the management and the right to request scrutiny.”[150] Although these provisions are aimed at protecting the minority shareholder, they apply to all the shareholders regardless of their percentage of shareholding and thus an incorporation decision keeping in mind the protection of the minority shareholders will benefit all shareholders including the promoters.[151]

Another area of company law that might provide the promoters the incentive to forum shop is the provisions on employee representation. It is such an area where agreements between countries have proven hard to be reached; as a result a number of directives have been abandoned and till now there are substantial differences between Member States regarding employee representation. Since this area is not harmonized, the differences between the Member States’ company laws might give the promoters the incentive to forum shop. For example, the German company law is known for its stakeholder primacy approach and it is feared by the German government that if race to the bottom becomes a reality in the European Union and competition between legal orders trigger, a large number of German companies might incorporate in another Member State in order to avoid the German rules on employee representation. However, the provisions on employee representation only apply to the companies with more than 500 employees and thus companies having fewer employees than that are likely to fall outside the scope of these provisions. As a result, the loss of new company incorporation due to the competition between legal orders largely depends on the promoters’ expectation of the growth of the company. As for the company that has already been incorporated, their possibility of moving out of the place of incorporation depends on their ability to reincorporate in another Member State. Therefore, if reincorporation is not possible and promoters expect the rules to be applied to the company in the future upon its

[150] Birkmose, A Race to the Bottom in the EU (n 126) 11
[151] Ibid 150, 11

growth, the rule on employee representation is likely to affect the original choice of incorporation.[152]

It is apparent form the above mentioned discussion that, although the ECJ has partially paved the way for regulatory competition but the fear of Delaware in European Union seemed unreal for at least a decade because of the lack of possibility of reincorporation. The next section will discuss companies' incentive for reincorporation.

Chapter 5

5.1 Reincorporation:

When a company is incorporated for the first time, it is the promoters who take the real decision regarding the place of incorporation because of their influence as investors. However, when it comes to reincorporation, it is hard to assume who makes the real decision. In theory, shareholders are the formal decision-makers but in reality, shareholders depend on the management for running of the company on a daily basis which leaves us to the principle agent problem where both the principles and the agents have different set of interests. According to the general principles in law and economics; it is assumed that the aim of the company is to maximize the shareholders' interest which is the maximization of share value.[153] Thus, if the management's interests differ from the shareholders' interests and where the main aim of reincorporation is to maximize the share value of the company, it is essential to determine who the real decision-makers are before establishing their incentives for re-incorporating a company.[154]

5.1.1 Who makes the decision?

In the American debate it is assumed that the managers are the real decision makers and this assumption is closely linked to the dominant ownership structure which is dispersed ownership.[155] Since the share ownership is dispersed across a large number of investors, it results in the separation of ownership from control because each shareholder has limited holding of shares and thus limited influence over the company. As the shareholders have

[152] Birkmose, A Race to the Bottom in the EU (n 126) 12
[153] Cf. among others, Daniel Fischel, 'The Corporate Governance Movement' 35 Vanderbilt Law Review 1259 (1982), 1262, 1265 and Roberta Romano, The Genius of American Corporate Law, 2.
[154] Birkmose, A Race to the Bottom in the EU (n 126) 13
[155] Adolf A. Berle and Gardiner C. Means, The Modern Corporation & Private Property, 112-116

limited influence over the company, it is assumed that the management rather than the shareholders take the actual decision which comes with agency costs. The only way the shareholders can influence the management of the company that has a dispersed share ownership structure, if they collaborate together. On the other hand, in most European Union Member States; concentrated ownership is the dominant ownership structure which means there is an overlap between ownership and control. Therefore, it is usually the shareholders who make the decision which means the basic condition for American debate is missing.[156]

5.1.2 Decision maker when ownership is dispersed:

Though majority of the companies in the EU have concentrated ownership, a number of companies have dispersed ownership structure in this region and the ownership structure is changing gradually with a growing percentage of companies with dispersed ownership.[157]

Since in the dispersed ownership structure, the shareholders have less control over the company; the managers might act opportunistically to pursue their own interests. Therefore, the shareholders must have sufficient instruments for controlling the managerial opportunism so that their interests are served. One such instrument is the shareholders' right to vote on certain important issues, like for example; the issue of reincorporation. Though, both in the United States and in the EU the shareholders formally take the decision of reincorporation by voting, it is debated whether it has any effect in controlling the management.[158]

Due to the proxy-system and collective action problems, the general assumption in America is that it is the management that controls the company and makes the real decision rather than the shareholders; in spite of their formal approval by voting. Before the shareholder meeting the management send the notice of the meeting along with form of proxy soliciting signatures from the shareholders. Since the shareholders are dispersed they have little incentive to attend the meeting, thus delegate the votes to the incumbent management by the use of proxy.[159] However, in order to protect the shareholders from the managerial opportunism by abusing the proxy system, the Securities Exchange Act of 1934 contains provisions on the use of proxies which require the proxy statement to include information on important matters that

[156] Birkmose, A Race to the Bottom in the EU (n 126) 13
[157] Cf. Lutgart Van den Berghe, Corporate Governance in a Globalising World: Convergence or Divergence? A European Perspective (Kluwer Academic Publishers, 2002), 49.
[158] The sceptics include Bebchuk, 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law', 1472 et seq. and Gordon, 'The Mandatory Structure of Corporate Law'.
[159] Birkmose, A Race to the Bottom in the EU (n 126) 15

are being put to the vote.[160] Therefore, shareholders in public companies would be able to make informed decision when submitting their proxy. Alternatively the shareholders can collect the information themselves which is costly and consequently shareholders with limited holding in a company would have little incentive to invest the resources necessary for becoming informed voter.[161] Again, another deficiency of the U.S. system is that the shareholders usually are not able to put an issue to the vote at the general meeting;[162] although in public companies it is possible for them to take advantage of the management's proxy solicitation under certain circumstances.[163] This will require the management to include the shareholder's proposal; that the shareholder intends to put forward at an upcoming shareholders meeting, with management's own proxy material.[164] However, the management is allowed to oppose the shareholder proposal by using a statement of their own with the proxy material. Furthermore, "this access to the proxy machinery has no application if the management does not solicit for proxies."[165] Moreover, rational apathy also applies in this case; consequently, in the U.S. it is the management who take the decision as well as initiative of reincorporation.

Making a direct comparison between the U.S. and the European system is quite difficult since they differ from each other in a number of ways. In the EU, decisions regarding important matters must be put to vote at the general meetings and as a result it can be assumed that the decision to reincorporate is formally made by the shareholders. However, it is unrealistic to assume that provision on shareholder voting in Europe will eliminate the problem of free riding and collective action especially when the ownership is dispersed and consequently, both the EU and the U.S. shareholders face identical situation. Again the right to vote doesn't ensure quality decision. Although a number of legislative initiatives have been taken in order to improve the condition of active ownership; namely, the one regarding the use of new technology in the general meeting so that it becomes easier for the small shareholders to participate in the general meeting, it is not sufficient for making an informed decision which requires access to relevant information prior to the general meeting. Therefore, legislations regarding the provision of information by the management need improvement, otherwise it

[160] Cf. SEC Rule 14A-4-14A-5.
[161] Birkmose, A Race to the Bottom in the EU (n 126) 15
[162] See among others, Cox, Hazen and O'Neal, Corporations, 323-325
[163] Section 14 of 'the Securities Exchange Act of 1934' and SEC Regulation 14(A), cf. United States Securities and Exchange Commission: Proxy Rules. Regulation 14A – Solicitation of Proxies.
[164] SEC Rule 14a-8, cf. United States Securities and Exchange Commission: Proxy Rules. Regulation 14A – Solicitation of Proxies.
[165] Birkmose, A Race to the Bottom in the EU (n 126) 16

wouldn't make any difference who the real decision maker is; because the outcome of a proposal that has been put to vote largely depends on the adequacy of the information provided. Alternatively, the shareholders themselves can collect the information regarding the proposed reincorporation so that they can make an informed decision by analyzing its effects on the company but collecting information on personal level is expensive. Another way the small shareholders can improve their quality of decision at the general meeting is by collecting information gathered by the institutional investors. Consequently, it is unlikely that the problems of free riding and collective ownership would be overcome by the shareholders in Europe and thus it can be assumed that management rather than the shareholders will be the real decision-makers in the European Union especially where the company has dispersed ownership.[166]

5.1.3 Decision maker when ownership is concentrated:

When the ownership structure of a company is concentrated, potentially there would be conflicts of interests between the majority shareholders and the minority shareholders. If a shareholder holds majority of the share in a company, that person might have other than financial interests in the company and thus will likely act opportunistically. Whether the shareholder acquired those shares after the company has already been incorporated or was a minority shareholders at the time of initial incorporation who turned into a majority shareholder through share purchase and therefore, couldn't influence the initial incorporation decision; depending on the situation the majority shareholder might want to reincorporate the company in a jurisdiction that is favourable to him even at the expense of the welfare of the other shareholders. Whether the majority shareholder would be able to adopt such a proposal himself depends on his percentage of the share holding as well as the majority requirement for approving such vote. Again, approval of such a proposal also depends on whether or not the majority shareholder's rights are restricted by voting ceiling or other similar provisions and if not he should be able to adopt such a proposal by himself. However, if the majority shareholder does not have enough shares to adopt such a proposal by himself, it is likely to be adopted since the problems of collective action and free riding also apply where ownership is concentrated. Furthermore, a majority shareholder is able to elect the management that will fulfil the majority shareholder's wishes and thus a proposal to reincorporate will not be blocked by the minority shareholders because of the problems relating to collective action

[166] Birkmose, A Race to the Bottom in the EU (n 126), 16-17

and free riding. In short, regardless of the number of shares a majority shareholder is holding; it must be assumed that he is the real decision-maker when ownership is concentrated.[167]

5.1.4 Incentives for the management to reincorporate:

When the management is the real decision-maker, they will act opportunistically and as discussed earlier; they will try to maximize their own interests. Favourable provisions of laws relating to some areas help the management maximizing their interests and thus work as incentives for re-incorporation. Areas that drive the management's incentives to reincorporate relates to provisions concerning job security, liability and freedom to manage the company.

Job security is a matter of concern for the management and since a hostile takeover is a threat to the job, regulation on takeovers has always been a matter of great importance for the management which in many cases work as an incentive for reincorporation. When a company is acquired by hostile takeover, in most cases the incumbent management is replace by new management appointed by the new owners and thus the incumbent management is always concerned how effectively they are protected from the hostile takeovers. It is generally assumed that the more difficult it is to takeover a company, the more secure the incumbent management's position is. Consequently, it is no surprise that choice of takeover regulations offered by the European Member States which are favourable to the incumbent management might be an incentive for reincorporation.[168] Although the Directive on takeover bids[169] has been adopted, it has not changed the situation because the optional provisions of the Directive allow the Member States to opt out of the rule against target boards taking action that may frustrate bids.[170] Therefore, there are substantial differences between Member States regarding the takeover regulations which provide the incumbent management the incentive to reincorporate because of its strong urge for protection against hostile takeover.

Again, provisions of company law that provide the management a greater degree of freedom for running the company also work as an incentive for company reincorporation. Such freedom might include the management's freedom on compensation package, whether or not it can award financial benefits to itself namely; determining the salaries, granting loans to managers, bonuses etc. Consequently, if the company law of a Member State proves

[167] Birkmose, A Race to the Bottom in the EU (n 126) P17-18
[168] Ibid 167, 18
[169] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.
[170] Mukwiri, J. The End of History for the Board Neutrality Rule in the EU. Eur Bus Org Law Rev 21, 253–277 (2020). https://doi.org/10.1007/s40804-019-00164-w

advantageous because it provides the management more controls over these financial matters; it will be an incentive for them to reincorporate the company to that Member State.[171] In addition to this, management's freedom for running the company includes their decision making power without involving the shareholders. When a company law offers the management the possibility to take strategic decisions without putting them for the vote at the general meeting, the management is likely to be interested in reincorporating the company to such a jurisdiction because it would be easier for the management to pursue their own interests.[172] Last but not least, the management is also concerned about the provisions on employee representation since it curtails their freedom to manage the company and thus, they will prefer to move the company to a jurisdiction where the company law is less stringent or has no such provisions regarding employee representation.[173]

Since managers act opportunistically to maximise their own interests, they are always concerned about their liability and the provisions relating to liability play an important role for choice of reincorporation law. The management of a company would like to maximise its interests at the same time minimise the liability; therefore, the company law of a Member State would only be attractive to the management for reincorporation if it comes with provisions that limit the management's liability. For example, when it comes to managers' degree of freedom to run the company, they would like to have large degree of freedom without the risk of being held liable for their decisions. Again, when it comes to the scope of self dealing; which "occurs when a manager enters into a contract with a company he manages, either in person or when such a contract is entered into between the company and other companies or persons in which the manager has a significant financial interest,"[174] the management would like to minimise their liability. Therefore, clear, unambiguous and pro-management company law provisions on manager's liability would be an incentive for the management to reincorporate the company.[175]

5.1.5 Incentive for the shareholders to reincorporate:

Although the general assumption is that the shareholders are the real decision-makers of the company, in reality who makes the decision largely depends on the ownership structure of the company. When the ownership is dispersed, it is the management who is the de facto

[171] Birkmose, A Race to the Bottom in the EU (n 126) 18
[172] Ibid 171, 19
[173] See Cheffins, Company Law: Theory, Structure and Operation, 442, 449.
[174] Birkmose, A Race to the Bottom in the EU (n 126) 19
[175] Birkmose, A Race to the Bottom in the EU (n 126) 19

decision-maker but if that assumption can be set aside and if it can be assumed that the shareholders are the decision-makers then according to the principle of law and economics; the possibility of maximising the value of the company in another jurisdiction will give them the incentive to reincorporate the company in that jurisdiction. However, when the ownership is concentrated, it is usually the majority shareholder who makes the real decision and majority shareholder's decision to reincorporate the company largely depends on two factors; financial and non-financial. If the majority shareholder has solely financial interests in the company, the provisions of company law that allow the majority shareholder to maximise the return on investment will be an incentive for reincorporation and this way both the majority and minority shareholders would be able to maximise their interests in the company. But if the majority shareholder has other than financial interests in the company; which is most often the aim of gaining control over the company, then the majority shareholder will act opportunistically. Therefore, the majority shareholder would have the incentive to reincorporate in a jurisdiction whose company law provisions would help him to gain the control over the company that is not possible under the company law of his home state.[176]

5.1.6 Scope of reincorporation in the EU:

The corporate law in the European Union emanates from the Member States[177]. Up until few years ago reincorporation in the EU were not allowed at all except for a number of countries (for example Italy, France and Spain) and till today most of the Member States do not admit "direct reincorporations" by way of transfer of registered office from home state to another state.[178] The situation is gradually changing due to the intervention of the European Court of justice (ECJ) and efforts from the EU policy makers. After years of effort, reincorporations were eventually liberalized by the EU derivative law. This was initially made possible by the adoption of the Regulation on the European Company (Societas Europaea, hereinafter "SE" and "SE Regulation")[179]. Although the SE corporations are established directly by EU law, they are only partially governed by the SE regulation and primarily governed by the laws of

[176] Birkmose, A Race to the Bottom in the EU (n 126) 19
[177] Jens C. Dammann, Freedom of Choice in European Corporate Law, YALE J. INT. L., 477, 487 - 491 (2004)
[178] Federico M. Mucciarelli, Freedom of Reincorporation and the Scope of Corporate Law in the U.S. and the E.U., LAW & ECONOMICS RESEARCH PAPER SERIES WORKING PAPER NO. 11-07 (March 2011), Available <<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783607>>
[179] Regulation of the Council 2157/2001/CE, October 8th 2001, on the statute of the European Company (hereinafter, The "SE Regulation"). << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02001R2157-20130701 >>

the Member State where the registered office is.[180] One of the main reasons of adopting SE Regulation was to create companies with EU legitimation so that it could overcome Member States' restrictions on transfer of registered office from one Member State to another by way of cross-border reincorporations. However, the SE is not a vehicle for free choice of law since it requires both the administrative seat and the registered office to be in the same country.[181] Therefore, with a view to changing the applicable law, the SE must move both its registered office and administrative seat into the new jurisdiction.

The adoption of the 10th Company law Directive on Cross-border mergers (present Directive (EU) 2017/1132 relating to certain aspects of company law)[182] eventually established the freedom of midstream reincorporation throughout the EU by way of cross-border merger. With the help of this Directive a company incorporated in a Member State could establish a new shell company in another Member State and then merge into it without taking the risk of being taxed at the state of origin like in the case of liquidation.[183]

Although, reincorporation through cross-border merger was an option for the companies, direct reincorporation was still not possible. This has been on the commission's agenda for several years and finally in 1997 a detailed proposal for a directive was presented for the first time which eventually was not approved.[184] Later on in 2002, the "high level group" which is a panel of corporate law specialists entrusted by the EU commission for developing proposals of European company law reform, recommended the liberalization of reincorporation throughout the European Union as a way to improve both efficient allocation of resources and quality of domestic laws.[185] Along this line, the Action Plan for modernizing the company law issued by the Commission in 2003 also prioritised the directive on cross border reincorporation[186] (also known as the 14th company law Directive). It would have not only

[180] Council 2157/2001/CE , SE Regulation, Article 9(1).
[181] Council 2157/2001/CE , SE Regulation, Article 7
[182] Directive (EU) 2017/1132 relating to certain aspects of company law repealed Directive 2005/56/EC on Cross-border mergers
[183] The then Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States; repealed by COUNCIL DIRECTIVE 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States
[184] Document XV/D2/6002/97-EN REV.2 (hereinafter the '1997 Proposal').
[185] High Level Group Report, "A modern regulatory framework for company law in Europe", available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf, p. 101.
[186] Communication from the Commission to the Council and the European Parliament - Modernising Company

allowed the direct reincorporations but also would have protected the minority shareholders, creditors and employees. But in 2007 when a full-fledge policy analysis was conducted, the project was abandoned by the Commission on the ground that harmonisation could be too onerous and does not provide evident advantages that outweigh the risk; in other words, not proportionate.[187]

Although, the case laws of the ECJ leave uncertainty, the impact they have in this area is significant. However, the Court of Justice (CJEU) has partially clarified certain issues in the relatively recent decisions in *Cartesio*[188] and *VALE*[189]. *Cartesio* a limited partnership formed in accordance with the Hungarian law intended to transfer its seat to Italy, while maintaining its legal status in Hungary. The ECJ was asked to assess whether freedom of establishment includes such an obligation for Hungary to permit a transfer like this. The Court ruled that 'a Member State has the power to define […] the connecting factor required' for a company to be incorporated under its law[190] and the Treaty does not regulate the connecting factor; consequently, *Cartesio* was not permitted to move its seat to Italy while retaining its Hungarian legal status. In its *obiter dictum* the Court stated that Member States can prohibit domestic corporations to transfer their headquarters abroad by using own substantive and conflict of law but cannot "require the winding-up or liquidation of the company, in preventing that company from converting itself into a company governed by the law of the other Member State".[191]

Furthermore, in *VALE*[192] which was an Italian limited liability company intended to convert into a Hungarian Company. The ECJ was asked whether freedom of establishment also includes conversion. In the judgment the Court mentioned that, although the provisions regarding the cross-border conversion of the Member State of arrival can be used; it must comply with the principles of 'equivalence and effectiveness'.[193] And the ECJ ruled that inbound cross-border reincorporation fall within the scope of the freedom of establishment,

---

Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, at 22 (COM(2003) 284 final).

[187] See Commission of the European Community, Impact assessment on the Directive on the cross-border transfer of registered office, Brussels, 12.12.2007 SEC(2007) 1707.

[188] C- 210/06 Cartesio Oktato es Szolgaltato bt [2008] ECR I-9641 (ECLI:EU:C:2008:723).

[189] C-378/10 VALE Építési kft. [2012] (ECLI:EU:C:2012:440).

[190] *Cartesio* para 110.

[191] Cartesio, para 112

[192] Ibid 189

[193] Ibid 189, para 57

provided that the company pursues genuine economic activity into the country of arrival.[194] However, the court made it clear that a mere relocation of registered office without any genuine link with the country of arrival is not protected by the Treaty.

Finally, *Polbud*[195] a Polish limited liability company intended to transfer its registered office from Poland to Luxemburg. The registered office of the company was transferred to Luxembourg upon a resolution adopted by the shareholder meeting. Subsequently, the company lodged an application with Polish registry court in order to remove it from the commercial register. However, the application was unsuccessful because it required evidence of successful execution of liquidation procedure. *Polbud* appealed against the decision which subsequently went to the Court of Justice for a preliminary ruling and the Court was asked whether the liquidation procedure under Polish law for removing the company from the Polish commercial register in order to register it in Luxembourg was compatible with freedom of establishment. The judgement mentioned that freedom of establishment also applies to the company that is established in accordance with the law of a Member State to the transfer the registered office from that Member State to another Member State in accordance with the law of the second Member State and for that purpose even though the company conducts its main, if not entire, business in the first Member State.[196] The ECJ ruled that freedom of establishment covers cross-border conversion with maintenance of legal personality and the liquidation was not a proportional and reasonable measure for protecting the internal interest of the state. Therefore, *Polbud* was allowed to move its sole registered office to Luxembourg without moving its headquarters regardless of its pursuit of any economic activity in Luxembourg.

Chapter 6

6.1 A race to the bottom in the EU?

The freedom of establishment granted by the ECJ has come to a point that the fear of competition between legal orders is getting close to a reality. After the decisions in *Centros*[197] and *Überseering*[198], companies were free to incorporate in the State with most

[194] *VALE* , para 34
[195] Case C-106/16 Polbud
[196] Case C-106/16 Polbud (para 38)
[197] Case C-212/97, centros

lenient laws and subsequently could carry on activities in other States with higher standards through branches or agencies.[199] For a long time there were uncertainties in the legal community regarding the extent of freedom of establishment; whether it only allows to choose the applicable law of the company during initial incorporation or this freedom extends to the situation when the company can change its applicable law in the course of its life time. *Polbud*[200] put an end to this controversy where the Court decided that freedom of establishment also covers the situation where a company transfers its registered seat to another Member State even if it will not perform any economic activity there. Therefore, it could be argued that the decisions in *Centros* and *Überseering* along with *Polbud* provided positive signal to the race to the bottom in the EU in the field of company law.[201]

The decision in *Polbud* did not prohibit regulatory arbitrage. According to the Court, the use of freedom of establishment for the sole purpose of benefiting from a more favourable tax regime was not an abuse in itself.[202] At least from the companies' perspective this could be an incentive for them to shop for low-tax regimes. A critic of this proposition could be that after the judgments in *Centros* and *Überseering*; companies were already able to forum shop and choose for the company law that best suits their need and therefore, why should the Member States be worried about tax shopping? The reason behind this fear is that, at that time it was not possible for the company that has already been established and doing business in a Member State to reincorporate in another Member State. Now with the established market for company incorporation coupled with the possibility of company reincorporation, the European Union is more vulnerable to a race to the bottom than ever before. Since tax residence of companies in the EU is determined by either of these two connecting factors; (i) the place of incorporation or registered office and (ii) the place of management or real seat, after the decision in *Polbud*, there might be an increase in letter-box companies; abusing the freedom of establishment to establish the company domicile in a more tax friendly Member State while conducting business elsewhere. Since, the change in company's registered office

[198] Case C-208/00 Überseering
[199] C. Barnard, The Substantive Law of the EU, The Four Freedoms, Oxford 2016, p. 394.
[200] Case C-106/16 Polbud
[201] Simona Frazzani and others, The Polbud judgment and the freedom of establishment for companies in the European Union: problems and perspectives, October 2018. << http://www.europarl.europa.eu/supporting-analyses >>
[202] The fact "that either the registered office or the real head office of company was established in accordance with the legislation of a Member State for the purposes of enjoying the benefit of more favourable legislation does not, in itself, constitute abuse", Polbud paragraph 40 quoted; Centros paragraph 27; and Inspire Art Ltd paragraph 96.

might change the tax residence of a company which plays a fundamental role in a Member State's taxing power; Member States might react in different ways and start producing laxer laws to prevent this from happening by providing already incorporated companies the reasons not to move or for attracting new incorporations, which might lead to regulatory competition in the EU. Consequently, this could give rise the majority shareholders' opportunism providing them the incentive to reincorporate in a jurisdiction that would give them the control over the company at the expense of the minority shareholders. Again, managerial opportunism might increase where the ownership structure is dispersed because of the production of laxer laws; providing them the incentive to reincorporate for the sake of company law provisions that provide them job security, freedom on compensation packages, no employee representation at the board and less or no liabilities for their actions at the expense of weak stakeholders. In response to this Member States might keep producing laxer laws in the hope of attracting new incorporations or reincorporations in their state, leading to a further meltdown in policy standards and consequently, a race to the bottom in the EU.

6.2 Is harmonisation a solution?

Much has been discussed about the prospects of 'Delaware effect' in the European Union without looking into the solution. The proposed solution to this problem by Professor William Cary is "the implementation of federal minimum standards".[203] Since the EU is not a federal state like the U.S., the solution to the problem in this part of the world would be the harmonisation of legislation at the Community level.

It's been over 50 years since the first initiative of top-down company law harmonisation was taken and although there has been approximation in some areas, harmonisation programme has not still been able to make company law uniform across the EU. Many reasons can be attributed to this failure but two main reasons that are worth mentioning are; the influence of different national interest groups and differences in national 'meta-rules'.[204] After *Centros*[205] and *Überseering*[206], law making (top-down harmonisation) in the EU has become intense but in reality not much has changed. The same applies for the bottom-up harmonisation; there has been some development in some areas of laws but little has been achieved in terms of

[203] Catherine Holst, European Company Law after Centros: Is the EU on the Road to Delaware, 8 Colum. J. Eur. L. 323 (2002)
[204] Enriques, A Harmonized European Company Law: Are We There Already, 66 Int'l & Comp. L.Q. 763 (2017), 8
[205] Case C-212/97 Centros
[206] Case C-208/00 Uberseering

uniformity. However, the final urge did not come until *Polbud*[207] which further facilitate the cross border conversions in the Community and strengthen the mobility of companies within the European Single Market. Therefore, the risk of 'Delaware effect' and regulatory competition between Member States in the EU has considerably increased that confirms an urgent need for positive harmonisation of cross-border operations in the Community. The case "calls once again for a cross-border transfer of company seats directive which should harmonize legal procedures (including connecting factors), deal with quorum and majority issues, provide minimum harmonization of the conflict of law rules and standard rules on minority shareholders, creditors and employees protection and therefore avoid the misuse of letter-box companies and shell companies".[208] Again, in the absence of harmonisation; the Member States' national laws and procedures are likely to diverge (in different areas) and in many cases it might give rise to majority shareholders' as well as managerial opportunism at the expense of weak stakeholders.[209] Furthermore, harmonisation in some areas of company law would benefit the companies by creating legal certainty on the one hand; it would also benefit other stakeholders; for example, creditors, minority shareholders and employees, by safeguarding their interests on the other hand. Now it's up to the Commission to take the initiatives for the harmonisation in these areas of laws which will strike a proper balance between the potentially diverging interests of all company stakeholders and in this regard, the past experience with Directive 2005/56/EC on cross-border mergers as well as the previous initiatives for Cross-border Company Migration Directive may serve as a guideline for the Commission.[210] The Commission has already taken some initiatives by publishing a proposal for a directive amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions[211]. The objective of the proposal were two-fold: providing "specific and comprehensive procedures for cross-border conversions, divisions and mergers to foster cross-border mobility in the EU while, at the same time, offering company stakeholders

[207] Case C-106/16 Polbud, EU:C:2017:804

[208] Corporate and M&A – The Polbud Case: Cross-border movement of companies / free transfer of registered office to Luxembourg – 20 December 2017, << https://kleyrgrasso.com/newsletter/corporate-and-ma-the-polbud-case-cross-border-movement-of-companies-free-transfer-of-registered-office-to-luxembourg-20-december-2017/ >>

[209] Stephan Rammeloo, Cross-border company migration in the EU: Transfer of registered office (conversion) – the last piece of the puzzle? Case C-106/16 Polbud, EU:C:2017:804, Maastricht Journal of European and Comparative Law February 2018, Vol.25(1), pp.87-107, p107

[210] Ibid 209, 87

[211] Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, COM/2018/241 final.

adequate protection in order to safeguard the fairness of the Single Market."[212] Consequently, Directive (EU) 2019/2121 of the European Parliament and of the Council amended Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions[213]. Apart from that, Directive (EU) 2016/1164 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, also known as the Anti-Tax Avoidance Directive (ATAD Directive)[214] and the proposed Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)[215] can be helpful for battling the 'Delaware effect' in the EU because exit taxation (Article 5 of ATAD aimed at coordinating national exit taxation provisions in the light of CJEU) will play an effective role in tackling tax shopping arising from the freedom to transfer the registered office; on the other hand, by reinforcing the link between taxation and jurisdiction; a fully-implemented CCCTB would reduce cross-border conversion for aggressive tax planning.[216]

6.3 Conclusion:

Fear of Delaware effect has been haunted the Community since the inception of the European Union and thus, in the absence of harmonisation of Community company law; in spite of real seat theory's possible conflict with the freedom of establishment, it was used in the Community for negating the fear of Delaware effect. However, the judgment in *Centros, Überseering* and *Inspire* opened the gate of regulatory competition in the European Union and it was feared that the fear of European Delaware turning into reality. In reality, this triad had an adverse effect on the real seat doctrine; especially after *Centros* it lost its prominence. And since in *Überseering* the principle of mutual recognition was affirmed; *Centros* together with *Überseering* established the market for company incorporations in the EU. However, this establishment of market for company incorporation was not enough for the European Union to have a market for regulatory competition. Because, for competition between legal order to happen; both the establishment of a market for company incorporation where the

[212] Simona Frazzani and others, The Polbud judgment and the freedom of establishment for companies in the European Union, (n 201) 28

[213] << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32019L2121>>

[214]Available << http://data.europa.eu/eli/dir/2016/1164/2020-01-01 >>, amended by Council Directive (EU) 2017/952 of 29 May 2017

[215] European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM (2011) 121 final/2, available <<https://www.europarl.europa.eu/meetdocs/2009_2014/documents/com/com_com(2011)0121_/com_com(2011)0121_en.pdf >>

[216] Ibid 212, 34

Member States compete with each other as well as the willingness of Member States and companies to compete, is a precondition. Again, the judgments in *Centros* and *Überseering* only established a partial market for company incorporation because a market for company incorporation needs both the ability to forum shop and the ability to reincorporate a company in another Member State; whereas the judgments only established a market for company incorporation with the ability to forum shop for the initial incorporation of the company. The other important element, the ability for the companies to reincorporate into another Member State in their lifecycle was missing for a long time. Apart from these, the paper also looked into the incentives for competition between legal orders from both the Member States' perspective and the companies' perspective and found that, at least from the Member States' perspective; it is lacking the most important incentive to compete that played the most significant role in the creation of Delaware which is franchise tax. Member States' ability to collect different kinds of indirect taxes and duties has been also curtailed especially by Directive on indirect taxes on the raising of capital and double taxation agreement. From the companies' perspective; although they had some incentives to take part in the competition, in the absence of the possibility to reincorporate in the EU this did not happen. However, the scenario changed after the judgment in *Polbud* which allowed cross-border conversion of companies even if they do not perform any economic activities in the Member State where they transfer their registered seat. With the last piece of puzzle found; after over a decade of *Inspire Art* judgement the fear of Delaware effect in the EU seemed real than rhetoric. Harmonisation could be a possible solution to this problem and thus, the Commission has already taken some initiatives to make some areas of company laws uniform in the Community so that a European Delaware does not emerge.

Table of cases

C-79/85 - Segers v Bedrijfsvereniging voor Bank- en Verzekeringswezen, Groothandel en Vrije Beroepen [1986] ECR I-02375

Joined cases C-71/91 and C-178/91, Ponente Carni, [1993] ECR I-1915.

Case C-113/99, Herta Schmid, [2001] ECR I-471.

Case C-106/16 Polbud

C- 210/06 Cartesio Oktato es Szolgaltato bt [2008] ECR I-9641 (ECLI:EU:C:2008:723).

C-378/10 VALE Építési kft. [2012] (ECLI:EU:C:2012:440).

Case C-4/97, Manifattura italiana Nonwoven, [1998] ECR I-6469.

ECJ Case C-212/97 of 9 March 1999, ECR 1999, 1-1459. (Centros)

ECJ Case C-208/00 of 5 November 2002, ECR 2000, 1-9919. (Überseering)

ECJ Case C-167/01 of 30 September 2003, in: DB 2003, 2219. (Inspire Art)

Table of legislations

Anti-Tax Avoidance Directive, available << http://data.europa.eu/eli/dir/2016/1164/2020-01-01 >>, amended by Council Directive (EU) 2017/952 of 29 May 2017

Consolidated Council Directive 2008/7/EC of 12 February 2008 concerning indirect taxes on the raising of capital

COUNCIL DIRECTIVE 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States

Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States

Council Directive 69/335/EEC 1969 O.J. (L 249/25).

Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, available << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32019L2121>>

DIRECTIVE (EU) 2017/1132 relating to certain aspects of company law

Directive (EU) 2017/1132 relating to certain aspects of company law

Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on takeover bids.

Directive 2005/56/EC on Cross-border mergers

Directive 89/666/EWG of 22 December 1989, Official Journal L 395/36

European Commission, Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM (2011) 121 final/2, available <<https://www.europarl.europa.eu/meetdocs/2009_2014/documents/com/com_com(2011)0121_/com_com(2011)0121_en.pdf >>

Model Tax Convention on Income and on Capital: Condensed Version 2017 , available << https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page30>>, Article 2(2) defines income tax and capital tax.

Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, COM/2018/241 final.

Regulation of the Council 2157/2001/CE, October 8th 2001, on the statute of the European Company, available << https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02001R2157-20130701 >>

The Securities Exchange Act of 1934’ and SEC Regulation 14(A), cf. United States Securities and Exchange Commission: Proxy Rules.

Others

Communication from the Commission to the Council and the European Parliament - Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward, at 22 (COM(2003) 284 final).

Document XV/D2/6002/97-EN REV.2 (hereinafter the '1997 Proposal').

High Level Group Report, "A modern regulatory framework for company law in Europe", available at http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf, p. 101.
https://financefiles.delaware.gov/Fiscal_Notebook/2019/2019-Fiscal-Notebook-FINAL.pdf

Corporate and M&A – The Polbud Case: Cross-border movement of companies / free transfer of registered office to Luxembourg – 20 December 2017, << https://kleyrgrasso.com/newsletter/corporate-and-ma-the-polbud-case-cross-border-movement-of-companies-free-transfer-of-registered-office-to-luxembourg-20-december-2017/ >>

Bibliography

ALTINIŞIK U, *Free Movement of Companies within the EU*, Ankara Bar Review 2012/ 1.

Balotti R. and Finkelstein J, *Delaware. Law of Corporations & Business Organizations* (Aspen Law & Business, 1999)

Bebchuk, Federalism *and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 1472.

Berghe L, *Corporate Governance in a Globalising World: Convergence or Divergence? A European Perspective* (Kluwer Academic Publishers, 2002), 49.

Berle A and Means G, *The Modern Corporation & Private Property*, 112-116

Birkmose H, *A Market for Company Incorporations in the European Union - Is Uberseering the Beginning of the End*, 13 Tul. J. Int'l & Comp. L.

Birkmose H, *A Race to the Bottom in the EU, Maastricht Journal of European and Comparative Law,* March 2006, Vol.13 (1)

Butler H, *Corporation-specific Anti-takeover Statutes and the Market for Corporate Charters,* Wisconsin Law Review 365 (1988), 377

C. Barnard, *The Substantive Law of the EU, The Four Freedoms*, Oxford 2016.

Cheffins, *Company Law: Theory, Structure and Operation*, 442, 449

Cox, Hazen and O'Neal, *Corporations*, 323-325.

Deakin S, *Regulatory Competition Versus Harmonisation in European Company Law*, ESRC Centre for Business Research, University of Cambridge Working Paper No. 163

Ebke W, *Centros - Some Realities and Some Mysteries*, 48 Am. J. Comp. L. 623 (2000)

Enriques, *A Harmonized European Company Law: Are We There Already*, 66 Int'l & Comp. L.Q. 763 (2017).

Fischel D, The *Corporate Governance Movement*, 35 Vanderbilt Law Review 1259 (1982)

Fischel D, *The "Race to the Bottom" Revisited:Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. REV. 913, 919-20 (1982)

Frazzani S and others, *The Polbud judgment and the freedom of establishment for companies in the European Union: problems and perspectives*, October 2018. << http://www.europarl.europa.eu/supporting-analyses >>

Gelter M, Centros, *the Freedom of Establishment for Companies, and the Court's Accidental Vision for Corporate Law* (February 13, 2015). Available at SSRN: <<https://ssrn.com/abstract=2564765 or http://dx.doi.org/10.2139/ssrn.2564765>>

Holst C, *European Company Law after Centros: Is the EU on the Road to Delaware*, 8 Colum. J. Eur. L. 323 (2002)

Jens C. Dammann, *Freedom of Choice in European Corporate Law*, YALE J. INT. L., 477, 487 - 491 (2004)

Kahan and Kamar, *The Myth of State Competition in Corporate Law*, 687-693.

Kersting C; Schindler C, *The ECJ's Inspire Art Decision of 30 September 2003 and its Effects on Practice*, 4 German L.J. 1277 (2003)

Kubler F, *A Shifting Paradigm of European Company Law*, 11 Colum. J. Eur. L. 219 (2005)

Looijestijn-Clearie A, Centros *LTD - A Complete U-Turn in the Right of Establishment for Companies*, 49 Int'l & Comp. L.Q. 621 (2000)

Macey J; Miller G, *Toward an Interest-GroupTheory of Delaware Corporate Law*, 65 Tex. L. Rev. 469 (1987)

Mucciarelli F, *Freedom of Reincorporation and the Scope of Corporate Law in the U.S. and the E.U.*, LAW & ECONOMICS RESEARCH PAPER SERIES WORKING PAPER NO. 11-07 (March 2011), Available <<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783607>>

Mukwiri J, The *End of History for the Board Neutrality Rule in the EU*, Eur Bus Org Law Rev 21, 253–277 (2020). Available <<https://doi.org/10.1007/s40804-019-00164-w>>

Norinder H, *The aftermath of Inspire Art-Applicability of the real seat theory and grounds for justification*, University of Lund (Master's thesis).

Roth W, *From Centros to Ueberseering: Free Movement of Companies, Private International Law, and Community Law*, 52 Int'l & Comp. L.Q. 177 (2003)

Sorensen K & Neville M, *Corporate Migration in the European Union: An Analysis of the Proposed Fourteenth EC Company Law Directive on the Transfer of the Registered Office of a Company from One Member State to Another with a Change of Applicable Law*, 6 Colum. J. Eur. L. 181, 186 (2000).

Villiers C, *European Company Law: Towards Democracy?*, Aldershot: Dartmouth, (1998)

Werlauff E, *The Main Seat Criterion in New Disguise – An Acceptable Version of the Classic Main Seat Criterion*, 2001 EUR. BUS. L. REV. 2, 3